

## ARGUING AGAINST THE ECONOMICS OF (SAY) CORPORATIONS LAW<sup>#</sup>

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### INTRODUCTION

It is amazing how the neoclassical variant of the economics of corporations law (also called the ‘modern theory of the firm’ and ‘agency cost theory of the firm’) repeatedly resurfaces, despite the general fragmentation of law and economics.<sup>1</sup> Bratton gives quite a good genealogy for the United States, locating its advent in 1972 with Alchian and Demsetz’s piece on shirking and, changing metaphors, its watershed in 1976 with Jensen and Meckling’s ‘well known analysis’ of the firm.<sup>2</sup> There was remarkably little impact in a still legalistic late 1970s Australia, the theory receiving just the occasional footnote. Yet back in the United States it gathered strength.<sup>3</sup> Whole issues of prestigious law reviews were devoted to it.<sup>4</sup> Perhaps inspired by these, there was a resurgence of Australian interest in the late 1980s and early ’90s;<sup>5</sup> Ramsay’s work probably best

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# This essay is dedicated to the memory of Michael Whincop – a true academic who would have recognised it for the tribute it is.

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1 See the discussion in ‘The Future of Law and Economics: Looking Forwards – Roundtable Discussion’ (1997) 64 *University of Chicago Law Review* 1132.

2 William W Bratton Jr, ‘The “Nexus of Contracts” Corporation: A Critical Appraisal’ (1989) 74 *Cornell Law Review* 407, 415. See also the excellent overview in Nicolai J Foss, Henrik Lando and Steen Thomsen, ‘The Theory of the Firm’ in Boudewijn Bouckaert and Gerrit De Geest (eds), *Encyclopedia of Law and Economics, Volume III The History and Methodology of Law and Economics* (2000) 631, <<http://encyclo.findlaw.com/5610book.pdf>> at 20 November 2003. I have cited articles from <http://encyclo.findlaw.com> wherever possible not only because it is readily available but also because the articles are generally excellent and provide comprehensive bibliographies that are not confined to one school of thought or one national tradition.

3 Bratton, above n 2, 409.

4 See, eg, (1983) 26(2) *Journal of Law and Economics* 1, 1–496; (1989) 89(7) *Columbia Law Review*, 1395–1774.

5 About this time Roman Tomasic, James Jackson, Brendon Pentony and Robin Woellner provided an excellent overview of ‘law and economics thinking about corporate law’, which now appears in Roman Tomasic, James Jackson and Robin Woellner, *Corporations Law: Principles, Policy and Process* (4<sup>th</sup> ed, 2002) 8–12 and *passim*.

represents this.<sup>6</sup> In the mid-1990s political approaches effectively drowned it out: for example, Bottomley's placement of it within liberal ideology, drawing fruitfully upon Frug.<sup>7</sup> Nevertheless, towards the end of that decade, not to mention the century and millennium, the celebration of the centenary of *Salomon's Case*<sup>8</sup> was marked by the defence of legal and political discourses against the economic: see, for example, the last four papers in the *Federal Law Review's Special Edition on Corporate Law: A Century of Salomon*.<sup>9</sup> Meanwhile, Cheffin's book on United Kingdom company law,<sup>10</sup> which uses economics extensively, became remarkably successful. Australia's own law reform effort, the Corporate Law Economic Reform Program ('CLERP'), heavily utilised the language of economics<sup>11</sup> and astringent Whincop articles on the economics of corporations law proliferated.<sup>12</sup>

While this was going on, Australian critique of the economics of corporations law was mostly muted, partial and *en passant*.<sup>13</sup> The most frequent textbook response was 'useful, but ...'; and the dots of the ellipsis did not meet the economics. Locating economics within liberal ideology does not turn out to be much of a critique but is more of a comment on the legal system. Questioning the assumptions – the reasonable evaluating maximising person is not the way we are, especially if we are not male,<sup>14</sup> perfect markets only exist as often as anything perfect, and so forth – receives, as demonstrated below, perfectly adequate responses derived from first year undergraduate courses in economics. In any case, one is tempted to say that, in business, it is acceptable to assume

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- 6 See, eg, Ian M Ramsay, 'Law and Economics as an Approach to Corporate Law Research? A Commentary' [1996] *Canberra Law Review* 48; Ian M Ramsay, 'Company Law and the Economics of Federalism' (1990) 19 *Federal Law Review* 169; Ian M Ramsay, 'Holding Company Liability for the Debts of an Insolvent Subsidiary: A Law and Economics Perspective' (1994) 17 *University of New South Wales Law Journal* 520; Ian M Ramsay, 'Corporate Law in the Age of Statutes' (1992) 14 *Sydney Law Review* 474.
  - 7 Stephen Bottomley, 'Taking Corporations Seriously: Some Considerations for Corporate Regulation' (1990) 19 *Federal Law Review* 203.
  - 8 *Salomon v Salomon* [1897] AC 22.
  - 9 (1999) 27(2) *Federal Law Review* 217–321.
  - 10 Brian R Cheffins, *Company Law: Theory, Structure, and Operation* (1997).
  - 11 David A Wishart, 'Corporate Law Reform: A Note on the Process and Program' (2000) 52 *Australian Company Secretary* 140.
  - 12 Usefully summarised in Michael J Whincop, *An Economic and Jurisprudential Genealogy of Corporate Law* (2001).
  - 13 Cf Andrew Fraser, *Reinventing Aristocracy: The Constitutional Reformation of Corporate Governance* (1998) ch 2; Neil Andrews, 'Bad Company? The Corporate Form in an Uncertain Law' (1998) 9 *Australian Journal of Corporate Law* 39; Neil Andrews, 'The Logic of Late Capitalism Illustrated' (1997) *Australian Journal of Corporate Law* 139. Despite these writers, and those mentioned earlier, theoretical discussions in Australian corporations law are mostly inconclusive: David A Wishart, 'The Absent Discussion in Australian Corporations Law' (1998) 15 *Law in Context* 142. There is a fair amount of literature in the United States, the principal exponent of critical comment being William Bratton, see especially Bratton, above n 2; in the United Kingdom see Paddy Ireland, 'Company Law and the Myth of Shareholder Ownership' (1999) 62 *Modern Law Review* 32; Paddy Ireland, 'History, Critical Studies and the Mysterious Disappearance of Capitalism' (2002) 65 *Modern Law Review* 120; David Sugarman, 'Reconceptualising Company Law: Reflections on the Law Commission's Consultation Paper on Shareholder Remedies' (1997) 18 *The Company Lawyer* 226, 228–37.
  - 14 Gillian Hewitson, *Feminist Economics: Interrogating the Masculinity of Rational Economic Man* (1999).

self-interest – why else is anyone involved?<sup>15</sup> And, if you can show otherwise, let us cordon them off or otherwise get rid of the situation. Hence, if the assumption does not describe well, then it ought to, and the economics applies. The result is an abandonment of the field of debate over policy formation to a particular theoretical construct.<sup>16</sup>

This paper attempts to enable head-on engagement with the economics of corporations law.<sup>17</sup> By doing so I hope to rediscover the abandoned debate. The economics it addresses is primarily economics of the welfare or normative kind – the one that recommends legal change.<sup>18</sup> The other sort, positive or descriptive economics, is all very well, and its practitioners can sit in a corner doing it, but it need not otherwise impact on our lives as lawyers concerned with governmental policy. This is except to the extent that its descriptions purport to be more true than any other description, that is, to be the basis of normative economics. This pretension is also challenged.

The critique of economics in this paper is organised around four themes relevant to corporations law. These, unfortunately, cannot be made discrete. They are:

- (1) epistemology;
- (2) laws;
- (3) the individual; and
- (4) markets.

The critiques are, at first, of general application, although some attempt is made to apply them to corporations law. The reason for the lack of critique specific to corporations law is that there is nothing special in the way economics has been utilised to analyse corporations law, and there is nothing special in corporations law to separate it out from other applications of economics. The economics is technical and unexceptionable. In my more sanguine moments, I suppose this is the reason for the seizure of corporations law by economic reasoning: there has been, over the last 10 years or so, too much going on in Australian corporations law for its academics to fully penetrate a whole additional discipline. The critique – or, rather, the bases for further discussion – I offer here is of the application of economics to corporations law, rather than of the actual economic analysis.

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15 'Corporate law "is not a branch of poverty law"': Whincop, above n 12, 20, citing Frank H Easterbrook and David R Fischel, *The Economic Structure of Corporate Law* (1991) 23.

16 See Bratton, above n 2, 410–11.

17 Lindy Edwards makes the compelling point that there is a vast distinction between economic theory and that which is implemented under the guise of policy: hence critique of, say, the Corporate Law Economic Reform Program may well be useless if directed at the difference between what is done and what economic theory would recommend, or even at the implementation of economic theory in the first place': Lindy Edwards, *How to Argue With an Economist* (2002). To persuade policy makers away from their course, argues Edwards, requires a simpler polemic, which she indeed provides. That is not to deny the utility of this essay, directed as it is to a more sophisticated critique than that with which Edwards recommends we address policy makers: I am naïve enough to believe that learning is necessary to rhetoric.

18 Paul Burrows and Cento Veljanovski, 'Introduction: The Economic Approach to Law', in Paul Burrows and Cento Veljanovski (eds), *The Economic Approach to Law* (1981) ch 1.

Corporations law comes to the foreground in the examples worked through towards the end of the paper. They are as to directors, constitutions and personality. The paper concludes by expressing my opinion as to the rather limited utility of economics in the study and operation of corporations law.

## I EPISTEMOLOGY

### A Modelling

Critiques of the law and economics of any area, including corporations law, usually state that the assumptions so necessary to economic reasoning are not real. Therefore, the recommendations of economics should not be the basis for action. The assumption most frequently raised in this context is the assumption of the rational actor. Undergraduate economics fields the argument by simply saying that no-one actually has to behave this way – what the economist does is treat society as if people do act rationally and when the results of so treating society are tested against the evidence of what happens in society, the treatment seems to match.<sup>19</sup>

The undergraduate response is an epistemological one: it is about the way of thinking deployed in economics. The key word is ‘model’. Positive economists try to create models of society that predict what happens. The predictions can be used to test the model against evidence about society to determine if the model is useful.<sup>20</sup> This process of model building is the claim of economics to being a science. It resonates with the language of the processes of the physical sciences: most particularly, Karl Popper’s description of science as a process of hypothesis and refutation.<sup>21</sup> And we rely on statistics to get around the problem of theory contingent evidence, that is the tendency of theory to define the measurable and hence to limit the possibility of refutation.<sup>22</sup>

Yet for many structuralism is dead, killed by paradigm if not quite intersubjectivity: Kuhn<sup>23</sup> trumps Popper.<sup>24</sup> Economists, then, converse with their fellows with shared language and understandings.<sup>25</sup> Modelling has a softer edge. It no longer claims truth, or lack of falsity, but is simply a process of working

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19 Milton Friedman, ‘The Methodology of Positive Economics’ in Milton Friedman (ed), *Essays in Positive Economics* (1953).

20 Burrows and Veljanovski, above n 18.

21 Karl Popper published his theories in many versions, directed at diverse ends. The book I am familiar with is *Objective Knowledge* (1972). More often cited are *The Logic of Scientific Discovery* (1959); *Conjectures and Refutations: The Growth of Scientific Knowledge* (1969).

22 Raymond A Morrow, *Critical Theory and Methodology* (1994) ch 1.

23 Thomas S Kuhn, *The Structure of Scientific Revolutions* (1970). We could even move to Lakatos’ ‘research programmes’ – Imre Lakatos, *Methodology of Scientific Research Programmes* (1978). See Gerrit De Geest, ‘The Debate on the Scientific Status of Law and Economics’ (1996) 40 *European Economic Review* 999.

24 See David A Wishart, ‘Resuscitating Popper: Critical Theory and Corporate Law’ (1996) 3 *Canberra Law Review* 99–103.

25 See generally Heico Kerkmeester, ‘Methodology: General’ in Bouckaert and de Geest (eds) above n 2, *Vol III The Regulation of Contracts* (2000) 383, <<http://encyclo.findlaw.com/0400book.pdf>> at 20 November 2003.

within a paradigm of knowing. Yet working within this paradigm is to acknowledge the existence of other paradigms of knowing and the fact that each describes in its own way. Each paradigm leaves elements of society out in what it recognises. Hence, statistics cannot now remove the problem of theory contingent evidence. If we view the world as a matter of contracts between individuals, which is all that we can see when we view corporations, then a corporation as a 'nexus of contracts' will thus be rendered devoid of meaning.<sup>26</sup>

'Still,' says the economist, 'can you come up with a better way of thinking? And, even if you do, I for one,' say they, 'still think economics is better.' And it may be. If so, it gives good grounds for action. So we must evaluate normative or welfare economics.

## B Normative or Welfare Economics

Normative or welfare economics is often very badly done. The main problem is the slippage between describing and recommending, between positive and normative economics. Richard Posner's undergraduate text, *The Economic Analysis of Law*<sup>27</sup> is just such a case, although the strict separation so important to current post-modern thinking is rarely found in anything other than as a matter of form in law and economics literature generally.<sup>28</sup> His core descriptive premise, that the common law produces efficient results, is deeply flawed. It turns out to be simple rationalisation.<sup>29</sup> His key normative proposition, that wealth should be maximised, fails when we ask – as Dworkin did – whether wealth is a value and, if not, what use is utility?<sup>30</sup> When these flaws are both present, it is difficult to discern whether the law under consideration is efficient when analysed economically, or ought to be made so were it analysed in that way. Hence, one never quite knows whether corporate constitutions are contracts or whether they should be. This very point seems to have been the stumbling block for the early economic analysis of Australian (and other United Kingdom-modelled) corporations law. In contrast to the various jurisdictions of the United States, corporate constitutions were already the way the early agency cost economics of the firm recommended they become. The constitutive portions of Companies legislation based on the *Companies Act 1948* (UK) are remarkably slight: 'director', 'shareholder', 'creditor' and 'employee' are not statuses created by statute but pre-existing phenomena regulated by the Act. Hence, it was slightly ludicrous to analyse the law and come up with the position the law had already adopted by logic decidedly lacking in formal economics. Thus, Australian

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26 Bratton, above n 2, 410.

27 First published in 1972, but now Richard A Posner, *Economic Analysis of Law* (5<sup>th</sup> ed, 1998). Posner's position has been significantly tidied up and the descriptive premise of the efficiency of the common law softened in much of his later work.

28 This is not to argue against normative thinking. The policy paralysis resulting from post-modernity is arguably that which has allowed the hegemony of utilitarianism against which this essay rails: Terry Eagleton, *The Illusions of Postmodernism* (1996) ch 1. My point is simply that we should be sufficiently educated to be able to consider things from many perspectives.

29 Neil Duxbury, *Patterns of American Jurisprudence* (1995) 411–14.

30 Ronald M Dworkin, 'Is Wealth a Value?' (1980) 9 *Journal of Legal Studies* 191.

corporations law made obvious the problem with the simplistic early versions of the economics of the firm: Just why did the law come up with the 'right' answer?<sup>31</sup>

Even apart from this slip-up, there is a major epistemological problem in normative economics. This arises from its reliance on the discourse of positive economics.<sup>32</sup> That, as we have seen, is a matter of simplifying the world in order to model it. Simplifying is a matter of taking complexity away. But what if important matters are left out in the simplifying process? How would we know, if testing the model relies on the model for definition of that which is to be tested? Thus, if positive economics leaves stuff out, then so also do the recommendations of normative economics. What, then, may be left out and how does normative economics deal with it? The features of society, particularly business life, rendered invisible in positive economic theory are the subject of the third and fourth sections of this paper, 'The Individual' and 'The Market' respectively.

There are two related problems with leaving stuff out. One is that mentioned above: that measurement of effect, if arising from the same discourse as the implemented recommendation, will not measure all the effects. This deserves further explanation. It is the famous Kantian dilemma of evidence being contingent on the theory that produces it.<sup>33</sup> While Popper's material idealist analytical schema and much recent postmodern sociology explores the real constraints of the mind on knowledge, the normative economist need not go so far, provided they are sufficiently humble in their recommendations: they should be aware that they may not be able to see the material world and that their metaphysics is strongly structuralist.<sup>34</sup> After all, the normative economist is trying to make things better, a purpose which the post-modern sociologist abjures.<sup>35</sup> Theory contingency does mean, however, that the effect of the implementation of recommendations should be measured from outside the theory making the recommendation.

Positive economics is partial in the sense that it examines what happens if one thing changes amongst all the other things, perceptible and imperceptible, that are happening. Hence the effect of the implementation of a recommendation based on a market constructed out of assumptions rendering certain things invisible should not be measured by the characteristics of the world as described by the theory. For example, Becker's work on the market for crime implied that

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31 Even Whincop, above n 12, finds the solution to this puzzle difficult: see David A Wishart, 'Critiquing Law and Economics: A Review of Michael J Whincop, *An Economic and Jurisprudential Genealogy of Corporate Law*' (2002) 14 *Australian Journal of Corporate Law* 74, 80.

32 As James Buchanan puts it, 'the ought is derived from the presumed is': James M Buchanan, 'The Domain of Constitutional Economics' (1990) 1 *Constitutional Political Economy* 1, as cited in Kerkmeester, above n 25, 390.

33 Morrow, above n 22. Denis Brion notes that 'a numerate approach tends to accept the results of measuring those factors that are susceptible to measurement as the proper order of things': Denis Brion, 'Norms and Values in Law and Economics' in Bouckaert and de Geest (eds) above n 2, *Vol I The History and Methodology of Law and Economics* (2000) 1041, 1049, <<http://encyclo.findlaw.com/0800book.pdf>> at 20 November 2003.

34 Kerkmeester, above n 25, 391-4.

35 Eagleton, above n 28.

increased sanctions resulted in less crime. Substantial research has indicated that Becker may well be right.<sup>36</sup> Hence, policy is implemented to increase penalties. Yet Becker's rational actor approach renders changes in individual preferences for crime invisible. No theorist with the slightest empirical knowledge of criminology would make a recommendation that ignores much more powerful approaches grounded in changing the preferences of the putative criminals.<sup>37</sup>

A much less obvious, but probably more pernicious, consequence of leaving stuff out of a description of the world is that the world becomes so constructed. Bratton writes of the neoclassical theory of the firm:

The theory's very appearance in legal theory affects practice. Its proponents advance a perspective that strikes deep political resonances as it recasts the basic components of received corporate theory in a classic, sometimes extreme individualist mode. ... This acceptance by itself reshapes prevailing consciousness ...<sup>38</sup>

Gillian Hewitson argues more generally that analyses based on the rational economic man help constitute reality:

Discourses, even those which are premised upon disembodied individualism, produce meanings beyond the conscious intentions of its authors. Specifically, the neoclassical economist implies that his or her analysis is independent of questions of sexual difference and the production of subjectivity by invoking a pre-existing, universal individual. ... neoclassical economics cannot deny its integral role in both producing and supporting phallogocentric constructions of that [sexual] difference.<sup>39</sup>

The process of theorising reconstructs the world to fit the theory. If the theory reifies rationality, rendering warmth and love invisible,<sup>40</sup> then perhaps these things cease to exist. To the extent that trust is essential to business,<sup>41</sup> perhaps trust ceases to exist and business becomes the poorer for it.<sup>42</sup> These consequences of theorising are far more powerful when the recommendations of theory are implemented as policy. We shall see how this works in the next section.

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36 Erling Eide, 'Economics of Criminal Behavior' in Bouckaert and de Geest (eds) above n 2, *Vol V The Economics of Crime and Litigation* (2000) 345, 359–60, <<http://encyclo.findlaw.com/8100 book.pdf>> at 20 November 2003.

37 Certainly the economic theorists have attempted to include other variables in their studies: Ibid 347–55, 361–4. See also Gary S Becker, *Accounting for Taste* (1996). Those theorists are not so stupid as to be blind to the rest of the world. Yet their theories consequently increase in complexity and Occam's razor becomes relevant. What use is a normative theory that requires extraordinary complexity to acknowledge the obvious?

38 Bratton, above n 2, 464.

39 Hewitson, above n 14, 212. See also the literature on 'government of the self': Barbara Cruickshank, 'Revolutions Within: Self Government and Self Esteem' (1993) 22 *Economy and Society* 326; Graham Burchell, 'Liberal Government and Techniques of the Self' (1993) 22 *Economy and Society* 267.

40 Robin West, 'Economic Man and Literary Woman: One Contrast' (1988) 39 *Mercer Law Review* 867.

41 Stewart Macaulay, 'Non-Contractual Relations in Business: A Preliminary Study' (1963) *American Sociological Review* 55.

42 Oddly enough, just as economics recognised cultural norms, attempts are made to theorise them as the results of rational choices: Kerkmeester, above n 25, 385–6.

## II LAWS

### A Efficiency as the Sole Ethical Criterion

As its name suggests, normative economics makes recommendations for law. Behind the resulting policies is the quest for 'efficiency': putting resources to their most valuable use in production, value being measured by what people express they want by their choices.<sup>43</sup> While most undergraduate textbooks on price theory will demonstrate how other ethical systems impact on recommendations based on efficiency, the core of normative economics is nevertheless directed at its attainment. I am not at this stage asserting that there is a difficulty with efficiency, although this is dealt with immediately below. Rather, I am suggesting that the economics deployed in, for example, agency cost theory of the firm only accedes to other ethical values as derogating from its own recommendations. Ethical considerations are, therefore, constructed as a contest between efficiency on the one hand and alternatives on the other, with the result in uncertain situations dependent on the burden of proof rather than a complex philosophical exercise. Moreover, that proof is often required to be within the discourse of economics, leading to the trap of theory contingency, as described above.

The contest between ethical systems represented by the much less ambiguous field of competition policy provides fascinating insight as to how dimly this issue is perceived. Provision for the public interest (sometimes set out in the form of particulars) to offset the demands of competition, competitive markets and hence efficiency often appears in instruments dealing with competition policy.<sup>44</sup> Yet one of the problems in competition policy and law is the variable nature of particular resolutions to the conflict between the two. Stemming from the Hilmer Committee report has been the position that, if there is no public interest discernible, competition policy is not to be implemented.<sup>45</sup> This is, of course, an extraordinarily radical stance. It places the burden of proof of public interest on those asserting it. The economic discourse is accepted as prevailing unless a positive failure to meet the public interest can be demonstrated. Whether that can be done will depend on the extent to which the text of the particular competition policy document demands that proof be within the discourse or not. Yet the Hilmer position remains unchallenged. I have argued elsewhere it was precisely this sort of difficulty, but one with the positions reversed, which forced upon us the form of the Simplification Program, and consequently the CLERP. Fear of

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43 There are many definitions of 'efficiency'. All deal with the use of resources. They differ as to who is using the resources (individuals, organisations, society), the time scale (now, the short run, the long run), the means of measurement (utility, wealth, money), what counts as resources (inputs, transaction costs) and the basis of comparison (monetary cost, cost-benefit, Pareto improvement). See Robin P Malloy, *Law and Economics – A Comparative Approach to Theory and Practice* (1990) 60–8.

44 See, eg, *Trade Practices Act 1974* (Cth) pt VII, dealing with authorisations and notifications of various anti-competitive activities on the grounds of the public interest; and variously in the Competition Principles Agreement entered into between the States and the Commonwealth on 25 February 1994 as to the implementation of competition policy.

45 Fred Hilmer, Mark Raymer and Geoff Taperell, Independent Committee of Inquiry into a National Competition Policy, *Review of the Committee of Inquiry into National Competition Policy* (1993) 18.

economic logic seizing the reform process forced a retreat from contentious policy reform.<sup>46</sup>

## B Efficiency Itself

Most law and economics scholarship, especially the economics of corporations law, contents itself with Paretian and Kaldor-Hicks definitions of efficiency. The Pareto efficiency criterion states that if a person chooses to do something then it must be taken to improve their happiness or 'utility', that social welfare is the sum of the happiness of individuals in society and that no change improves the welfare of society unless it is preferred by at least one person without diminishing the utility of any one else. Kaldor-Hicks efficiency, the foundation of cost-benefit analysis, allows for that diminution, provided the gain to the winners outweighs the loss to the losers – but, of course, that removes, as the price of practicality, the attractively hermetic, subjective nature of Pareto. Efficiency defined in the latter way is hence ethically less attractive. But even in its impractical pure form, efficiency as an ethical criterion for action is available for critique, quite apart from its status as the sole ethical criterion in the normative economics involved in the discussion of corporations law.

Efficiency is a measure of social welfare, determined in its Paretian form by the preferences of individuals. In other words, it converts the preferences of individuals into social welfare. It is thus intimately connected to liberal and utilitarian philosophies. As such, it has difficulty with notions of rights and fairness.<sup>47</sup> More generally, utilitarianism is but a branch of moral philosophy and it is impossibly naïve to recommend on the basis of efficiency without at least noting the qualifications upon it as a criterion of right law-making.<sup>48</sup> After all, Mill, Smith and Bentham all located their economics within moral philosophy. Moreover, Pareto's efficiency makes no judgment on the subjective value of anything, rendering law-making impossible because we can never know whether a change in law did in fact cause some form of loss to someone. And Kaldor himself, in the co-development of the Kaldor-Hicks form of efficiency, required a degree of relative equality in the distribution of wealth to make cost-benefit analysis work.<sup>49</sup> Efficiency, then, is far from unproblematic as a policy.

## C Implementation

Normative economics generally makes recommendations, normally with efficiency as the sole ethical criterion. These recommendations must be implemented. This is done by a variety of means: usually by government – an

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46 David A Wishart, 'Simplification and Motherhood' (1996) 2 *Butterworths Corporations Law Bulletin* 16–19; David A Wishart 'Corporate Law Reform: A Note on the Process and Program' (2000) 52 *Australian Company Secretary* 140.

47 Howard Chang discusses both and comes to a valiant reconciliation: Howard Chang, 'A Liberal Theory of Social Welfare: Fairness, Utility, and the Pareto Principle' (2000) 110 *Yale Law Journal* 173.

48 See generally David Lyons, *Forms and Limits of Utilitarianism* (1965).

49 Nicholas Kaldor, 'Welfare Propositions of Economics and Inter-Personal Comparisons of Utility' (1939) 49 *Economic Journal* 549. A relative degree of inequality was also required to make this analysis work.

irony, due to government's preference for markets. In terms of competition policy, for example, normative economics recommends the break-up of utilities, the corporatisation of government-owned businesses, competitive neutrality between government-owned businesses and privately-owned businesses, legislative reviews to ensure restrictions on competition are justified by the public interest (howsoever defined), a set of laws guarding competition against collusion, the acquisition of monopoly power, the abuse of already acquired monopoly power and some other practices found to a greater or lesser extent to be inefficient.<sup>50</sup> Creating and enforcing laws are two of the techniques by which these recommendations are implemented. Naturally, there are other techniques. Selling assets does not necessarily require laws – although it may well, perhaps must, be empowered by law. Similarly, corporatising a government-owned business enterprise may involve the registration of a company, the exercise of powers conferred on the organs of the company and the sale of assets by the Crown to the company. The law plays some part in all of these, but is not the direct means by which the policy is effected. This distinction between law and other governmental techniques is not maintained in normative economics. It is indifferent as to the means by which its recommendations are carried out.

It is not necessarily wrong to fail to distinguish between laws and other techniques of governance employed by a government. After all, the distinction has puzzled many lawyers and is the focus of much jurisprudence. Further, abandonment of the distinction as a significant discursive boundary has many advantages.<sup>51</sup> Yet one would have thought that to do so involves an appreciation of the nature of each particular technique deployed. This is lacking in normative economic thought generally,<sup>52</sup> and the theory of the firm in particular.<sup>53</sup> This is not to say that normative economics is wrong, merely that it fails to specify how its recommendations can be carried out. They may be unrealistic or unenforceable. Prohibiting price-fixing may be an example of one such impossible stricture.<sup>54</sup> Further, in adhering to the simplistic positive conception of laws as rules backed by sanctions, it fails to acknowledge that there may be far simpler and cheaper alternatives to desired outcomes: utilising the declaratory effect of laws or altering the preferences of people by other means may be

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50 Hilmer, above n 45; the Australian set of laws is to be found in pts IIIA and IV of the *Trade Practices Act 1974* (Cth). Of course, there are disagreements as to the necessity for, ambit and form of these recommendations. Thus, for example, some would dispute the necessity for a general proscription on collusion, being of the opinion that the incentives to drop out of the cartel will always overcome the incentive to stay in it: see Stephen G Corones, *Competition Law in Australia* (2<sup>nd</sup> ed, 1999) 10–13.

51 David A Wishart, 'Theory, Politics and the Reform of Corporations Law (or Corporations Law as a Glob)' (2002) 6 *Law, Text, Culture* 87.

52 Cento J Veljanovski, *The New Law-and-Economics: A Research Review* (1982) pt 3; and in neo-liberalism generally: Eagleton, above n 28, 78–88. This reflects the ambiguous position of the state in law and economics literature: See Simon Deakin, 'Law Versus Economics? Reflections on the Normative Foundations of Economic Activity' in Megan Richardson and Gillian Hadfield (eds), *The Second Wave of Law and Economics* (1999) 30, 41–7.

53 Wishart, above n 12, 79–81.

54 The prohibition is *Trade Practices Act 1974* (Cth) s 45A. See also Adam Smith, *The Wealth of Nations* (1776): 'People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices'.

considerably more effective.<sup>55</sup>

The abandonment of the consideration of implementation may lead to a misconception of what normative economists recommend. The processes by which laws, or any other technique of government, are formulated are long and tortuous. While they take place, there is ample scope for both deliberate and voluntary misunderstanding. Lindy Edwards graphically illustrates this in *How to Argue with an Economist*,<sup>56</sup> distinguishing between what economists recommend and the policies adopted within the political apparatus of the state. The latter is 'economic rationalism' and consists of a number of simplified statements, representing the propositions of economics, and by which issues are to be judged. An obvious example is the CLERP in which the rhetoric of reform on economic principles is only faintly matched by the masses of reforming legislation formulated under it.<sup>57</sup> Again, this is not to deny the recommendations of normative economics, it merely asserts that their implementation may be problematic. And this should come as no surprise to the economist, for it is the implication of their very own discipline, amongst others, in the form of public choice theory.<sup>58</sup>

If implementation is not a matter for the normative economist, a sloppiness creeps into the very idea of recommending. This I adverted to above, when describing the epistemological difficulties of normative economics. I noted that there frequently is a slippage between describing and recommending, resulting in the rather unnecessary conclusion that the common law produces efficient results. This highlights the ambiguous position of the common law in normative economics and, more generally, the equivocal description of the state. Is the common law a function of the state and, therefore, regulatory of freely entered into contracts, or is it a necessary institution allowing contracts to function by resolving disputes and settling property rights? Empiricism does not help because business people rely more on good faith<sup>59</sup> but to a decreasing extent<sup>60</sup> as perhaps, rational actor theories and economic analysis generally become internalised.<sup>61</sup> When, for example, Calabresi and Melamed distinguish between claim and property rules in tort,<sup>62</sup> what are we supposed to do about it? Conveniently, Landes and Posner found that the United States common law has produced the

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55 Implicated here is the assumption of stable preferences critiqued above as narrowly limiting the range of recommendations for action: see text accompanying nn 36–37.

56 Lindy Edwards, *How to Argue With an Economist* (2002).

57 See Wishart, above n 51.

58 The seminal text upon which much of this is built (although to my mind it is just 'Yes, Minister' in other words) is James M Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (1962).

59 Macaulay, above n 41. See generally Vivien Goldwasser and Tony Ciro, 'Standards of Behaviour in Commercial Contracting' (2002) *Australian Business Law Review* 369.

60 Alessandro Arighetti, Reinhard Bachmann and Simon Deakin, 'Contract Law, Social Norms and Inter-firm Co-operation' (1997) 21 *Cambridge Journal of Economics* 171.

61 See text accompanying nn 38–39.

62 Guido Calabresi and Douglas Melamed, 'Property Rules, Liability Rules, and Inalienability: One View of the Cathedral' (1972) 85 *Harvard Law Review* 1089.

efficient result for tort,<sup>63</sup> for whatever reason, but even the late Michael Whincop found that the Australian courts are unable to make the same claim for corporations law.<sup>64</sup> Yet without the presupposition of the production of efficient solutions, the initial legal precepts upon which law and economics builds,<sup>65</sup> the always-already-there law, derogate from the stance that efficiency is a good thing. For those precepts may be allocatively inefficient, even if they are not distributionally suspect.

These considerations point to the disunity in the various schools of law and economics: between the Chicago variants, the Yale school, perhaps the New Haven school, and then further afield to the Austrian school and the institutionalists generally.<sup>66</sup> The necessity for and the form of state action to create the environment for markets is a primary distinction between these schools of thought, as is the reliability of the courts in coming up with efficient solutions, and their relative roles in state action. These distinctions do not arise from empirical studies, even were they possible, but from the values upon which the theories are based. Recommendations thus suffer in two ways: the efficiency criterion is always within a penumbra of values and no firm directive as to how it should be achieved is possible.

### III THE INDIVIDUAL

#### A The Rational Actor

As demonstrated above, the critique of economics which asserts that the assumed rational actor is not real is met by an epistemological response. The best rebuttal is to meet on the grounds of epistemology: to deny structuralism.

Unfortunately, you, gentle reader, are not necessarily a postmodernist and may insist on the question of what is wrong with the theory, rather than the question of what is wrong with theory. As is averred above, this lies in what is left out or is rendered invisible. Further critique founded on the nature of the person in economics is rendered possible by looking at these gaps. However, the criticism is not simply that there is some disjunction between people in society and the rational actor in economics. The criticism is also that happiness is measured in economics solely by the expression in people's choice of preferences.

#### B Citizenship

Notable within all efficiency criteria is the idea that the collective choices of

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63 William J Landes and Richard A Posner, 'Legal Precedent: A Theoretical and Empirical Analysis' (1976) 19 *Journal of Law and Economics* 294.

64 Whincop, above n 12, 31–40 and *passim*.

65 Ronald H Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1.

66 Gary Minda, 'The Law and Economics and Critical Legal Studies Movements in American Law' in Nicholas Mercuro (ed) *Law and Economics* (1989) 111–12; Ejan Mackay, 'Schools: General', in Bouckaert and de Geest (eds) above n 2, *Vol I The History and Methodology of Law and Economics* (2000) 402, <<http://encyclo.findlaw.com/0500book.pdf>> at 20 November 2003.

individual people define social happiness. Markets convert individual choices constructed by freedom and happiness into the supply by society of those things desired. People who choose are thus the citizens of the market polity.

A useful exercise is to count the people that are the citizens of the market polity; perhaps easier is to count those people who are not such citizens. They are those who cannot choose, or perhaps cannot choose sufficiently to participate generally in the market-governed segment of society or even cannot participate in any one of the markets providing them with the goods and services the subject of utilitarian happiness. People are disabled from choosing, either in general or sometimes, for a multitude of reasons. Perhaps the reasons are simply physical: they are too old and frail, or cannot get to the place of choosing (shopping centres, professional suites and so forth) for some other physical reason such as disease, injury or congenital disability; perhaps they are mentally incapable of choosing because they are too young or they are diseased, or, and this can be a different category, their patterns of thinking do not involve the processes of choice demanded by markets in which choices are made.

This idea of citizenship applies to markets for securities. Those accepting their usefulness assume that shareholders choose exit, voice or passivity; that the agency of directors is about dealing, perhaps even taking risks, with the funds of capital providers; some politicians even refer to shareholder society – constructing the shareholders as expressing their citizenship through participation in those markets. Yet even disregarding those who are forced to participate, perhaps through compulsory superannuation, there are many reasons why people may not see the shares as something about which they can choose to do anything. There may be something of a sense of belonging, a sense of holding the shares on trust for future generations, or even some cultural or gender inhibition on right conduct. The same is true for those termed lenders whether they are unintentionally so or not, and for employees. While all of these can be brought within the description of society in positive economics, to govern that society as if they choose – in the utilitarian sense – is to force upon them forms of expression they may not accede to, it is to disable their citizenship.

### **C Choosing**

The foregoing suggests that choosing between material preferences may not be possible for some people. This argument can be expanded to a proposition somewhat similar to the point discarded before, but one that does have a degree of validity. Rather than the simple assertion that the person as conceived of in positive economics is not a picture of the way people are, the argument should be that to govern us as if we choose – as economics conceives us as doing – oversimplifies our actual processes and hence distorts the process of governance. Happiness, says Pareto, is the expression of revealed preferences or, to put it another way, we would not do a thing unless we wanted to. But happiness is not necessarily that. Psychology tells us our preferences change – advertisers rely on this. Yet mutable preferences are untenable within even positive economic

theory. Not only do our preferences change over time, but we can and often do prefer A over B and B over C at the same time as preferring C over A.<sup>67</sup> A multitude of psychological theories interrogate the way decisions are made. A unifying aspect of all of them is a rejection of rational actor theory.<sup>68</sup> In any case, neurosis and martyrdom are prevalent. Any idea of a ranked preference set therefore fails. Subjective happiness may not be the product of choosing. Objective utilitarian happiness is therefore but a construct.

Psychology and sociology both tell us that the way we are, and the way we view ourselves, is the product of our context. We are as fictional as firms. To render economic governance workable, either economics incorporates more people by measuring happiness more subjectively than via revealed preference sets, or accepts exclusion and actively constructs its citizens to see themselves as choosers. The former is, of course, exactly what normative economics was constructed to avoid: how can we know what makes someone else happy? In the latter, the world is remade in the image of the discourse. Society is made to fit the assumptions of economics: individuals rationally utility maximise, firms profit maximise, relations between rational actors are discrete and presentiated transactions<sup>69</sup> and so forth.

It may seem farfetched to assert that society is being remade to make theory work, but why else are friendly societies forced to account in terms of profit, mutuals encouraged to demutualise and universities conceived of as enterprises? The same is true for you and I. We increasingly perceive ourselves as contracting individuals – as carrying out aims and objectives.<sup>70</sup> Thus, for better or worse, children are encouraged to govern themselves in their relations with carers by a contractualisation of that relationship.<sup>71</sup> Institutions and people are constructed within the discourse of positive economics so that we, and those institutions, are rendered governable by the recommendations of normative economics. Yet what we become, and the way society is, may not be what we would want.

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67 Buchanan and Tullock, above n 58.

68 See, eg, Gary A Klein et al (eds), *Decision Making in Action: Models and Methods* (1995); William M Goldstein and Robin M Hogarth (eds) *Research on Judgment and Decision Making* (1997). Even positive economic theory of contract law is forced to deal with the failures of rational actor theory: see Michael M Trebilcock, *The Limits of Freedom of Contract* (1993) 118; Melvin E Eisenberg identifies recognition of the limits of decision-making within contract law in terms of distress, transactional incapacity, unfair persuasion and price ignorance: 'The Bargain Principle and its Limits' (1982) 95 *Harvard Law Review* 741.

69 These horrible adjectives are used and coined respectively by Ian R Macneil: 'Contracts: Adjustments of Long-Term Economic Relations under Classical, Neo Classical and Relational Contract Law' (1978) 72 *Northwestern University Law Review* 854. Discrete in this context means that it is the only thing covering the situation and is complete in itself, and presentiated means that an attempt is made to provide for all future contingencies – brought into the present.

70 Cruickshank above n 39; Burchell above n 39.

71 Passing reference to child-care manuals makes this obvious. The ones on my bookshelf include Steve Biddulph, *The Secret of Happy Children*, but particularly the sequel, *More Secrets of Happy Children* (1994) ch 3; Christopher Green, *Toddler Taming* (1984) ch 6; Bob Montgomery and Laurel Morris, *Getting on with your Teenagers* (1988) units 15–26. The process is even more obvious in the strategies adopted by teachers and principals to cope with (at least my) children: the contract to complete homework, the contract to behave in certain ways and so forth.

## IV MARKETS

### A Markets and Institutions

The type of economics applied to corporations law generally prefers markets to government. Other schools of thought move towards institutional design and talk of the nature of institutions in which individual qualities other than self-interest are recognised.<sup>72</sup> The feature of agency cost theory – the foundation of much of the economics of corporations law – was to see even institutions, including the firm, as being able to be represented as self-interest in markets. In this theory complex, human interactions are reduced to self-interested discrete and presentiated transactions dealing with moral hazard – the tendency to shirk contractual duties. An extraordinary amount of observable phenomena is rendered invisible, such as governance structures, organisational memory, culture, bargaining power, gullibility and stupidity. Yet it can be prescriptive, whereas the institutional perspective is generally<sup>73</sup> merely descriptive (positive, if you like) and does not lend itself to governance.<sup>74</sup> However, neither would agency cost theory, were it not for the supposition that markets are better because they are efficient, and efficiency is better than government because it is the free expression of preferences. Government, in this schema, is coercive and therefore bad. On the other hand, as we shall see, so also are markets. Further, far from being the antithesis of governments, markets depend on governments to construct property<sup>75</sup> and persons.<sup>76</sup>

The work of many economists lies in this gap between the neo-classical discrete and presentiated contract and the institutional economics of Veblen and Commons. We can see a little of their work, particularly Transaction Cost Economics and Property Rights Theory, now creeping back into the economic theory of corporations law in response to exactly the type of critique that I am making now.<sup>77</sup> I would expect a move to game theory explanations of organisational structures in firms to appear soon, deriving from work on social norms, customs and institutions, even ideology.<sup>78</sup> However, much of it still subscribes to notions of methodological individualism, ‘couching its explanations in terms of the goals, plans and actions of individuals’.<sup>79</sup> This may not be a complete acceptance of the rational actor – the reasonable, evaluating,

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72 Burrows, above n 18. Institutional economics goes back a long way, although in its modern form it starts with John Commons: see Steven G Medema, Nicholas Mercuro and Warren J Samuels, ‘Institutional Law and Economics’ in Bouckaert and de Geest (eds) above n 2, *Vol I The History and Methodology of Law and Economics* (2000) 418, 419, <<http://encyclo.findlaw.com/0520book.pdf>> at 20 November 2003.

73 Schmid discusses various formations of institutional economics: Allan Schmid ‘Law and Economics: An Institutional Perspective’ in Nicholas Mercuro (ed) *Law and Economics* (1989) 57.

74 Ronald H Coase, ‘The New Institutional Economics’ (1984) 140 *Journal of Institutional and Theoretical Economics* 229, 230.

75 Coase, above n 65.

76 Peter Miller and Nikolas Rose, ‘Governing Economic Life’ (1990) 19 *Economy and Society* 1, 21–5.

77 Exemplified in Whincop, above n 12, ch 1.

78 Peter G Klein, ‘New Institutional Economics’ in Bouckaert and de Geest (eds) above n 2, *vol I The History and Methodology of Law and Economics* (2000) 456, 462 <<http://encyclo.findlaw.com/0530book.pdf>> at 20 November 2003.

79 Ibid 457.

maximising person of neoclassical economics – because it often concedes bounded rationality and opportunism to the individual.<sup>80</sup> To the recently trained sociologist, it is a Weberian explanation<sup>81</sup> ignoring the problems of post-modernity. As modelling, it is far too partial and incomplete to predict much more than the obvious and as a prescriptive schema it falls into the epistemological and implementation difficulties I noted above. To the latter, there is one caveat: some theorists choose to recommend on the basis of comparative institutions – a familiar approach from political economy,<sup>82</sup> but explicitly adopted by Coase.<sup>83</sup> Yet this is not much of an improvement over efficiency for, in as much as efficiency depends on initial ascriptions of property rights, so comparative institutions is a matter of assumed value systems or – within the language of economics – of ascribing property rights.<sup>84</sup> Certainly a tendency toward transaction cost reduction in the evolution of institutional form tends to be assumed,<sup>85</sup> leading to the further circularity that the desirable feature of efficiency is necessarily to be found in existing institutions in competitive situations; hence the process of empirical investigation is merely a matter of finding out what the transaction costs are, and how they were minimised in the given circumstance. This can say nothing about whether or not the costs were in fact minimised.<sup>86</sup>

## B The Preference for the Status Quo

That markets are better is a limited proposition. This even its adherents would admit. One such admission would be that the status quo is preferred: markets only enhance what people have. If they have nothing, there are no transactions into which they can enter. The lack of redistributive consequence is clear. Certainly, initial property distributions determine the efficient property distributions when markets are cleared, and there are therefore an infinite number of possible efficient solutions to utility maximisation.<sup>87</sup> But that, these adherents would chorus, is not their concern. Yet it is. For in constructing markets the initial distribution of property rights determines transaction costs, and we are advised that transaction costs are waste, and therefore that we ought to determine that property lies with least cost risk avoidance.<sup>88</sup> Yet surely there are issues of equity in this determination, issues which are quite outside Pareto's ethic.

Take, for example, the contractualisation of the relationship between the

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80 See especially the work of Oliver E Williamson, for example, 'Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law' (1979) 22 *Journal of Law and Economics* 233.

81 For example, MacNeil's listing of transaction costs (see MacNeil, above n 69) is remarkably similar to that provided by Toennies at the turn of the century.

82 Charles E Lindblom, *Politics and Markets: The World's Political Economic Systems* (1977).

83 Ronald H Coase, 'The Regulated Industries: Discussion' (1964) 54 *American Economic Review* 194, 195.

84 Schmid, above n 73, 68.

85 Klein, above n 78, 470–1.

86 Veljanovski, above n 52, 97.

87 Coase, above n 65; C Edwin Baker, 'Starting Points in the Economic Analysis of Law' (1980) 8 *Hofstra Law Review* 939.

88 Calabresi and Melamed, above n 62.

government and welfare recipients: nominated the doctrine of mutual obligation.<sup>89</sup> The market for welfare is constructed by the allocation of property rights in welfare income streams to the government so that they may be traded for the reconstruction of the welfare recipient's personality in line with governmental expectations. Yet that allocation was only made possible by the conceptualisation of welfare income streams as property. Ironically, this formulation was originally developed by Macpherson<sup>90</sup> in order to legitimise welfare: each person had a property right in those income streams. Having been so formulated, however, it was but a small step to allocate the property to the government in order that it be traded. In return for access to the property represented by income streams, individuals reconstruct themselves to fit the notion of what the government dictates is a contributing citizen.<sup>91</sup> This, the doctrine of mutual obligation, has been characterised by intense ethical debate for the reason that the distribution of property rights is not a matter of efficiency. That allocation should be the product of an ethical debate, rather than simply a matter of assumption, resumption or transaction cost reduction.

### C Market Imperfections

The mission of the normative economist is to remove the imperfections in markets to make the markets work.<sup>92</sup> This leads to two difficulties. First, what if there are imperfections that cannot be removed? There is a theoretical issue in economics called the problem of second best.<sup>93</sup> It states that, if there is but one market that is necessarily imperfect, there is no way of establishing that any other market is efficient. All markets are interlinked and misallocations of resources can simply compound. Generally in situations of, say, natural monopoly, in order to avoid the compounding effects of the imperfection, the task is to create that allocation of resources which would be that performed by a market. Yet that leads to some extraordinarily difficult problems for competition policy.<sup>94</sup> And, in any case, utility is not just a way of allocating resources or of creating wealth. To think so was Posner's mistake. Utility also involves preferences for certain things to be determined by the government. Given that recommending becomes a matter

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89 See generally Terry Carney, Gaby Ramia and Anna Yeatman (eds), *Special Issue: Contractualisation and Citizenship* (2001) 18 *Law in Context* 1.

90 Crawford B Macpherson, 'Capitalism and the Changing Concept of Property', in Eugene Kamenka and Ronald S Neale (eds), *Feudalism, Capitalism and Beyond* (1975) 104, 120–4.

91 See the Government White Paper on Welfare Reform: Patrick McClure (Chairperson), Reference Group on Welfare Reform, *Participation Support for a More Equitable Society*, Canberra: Department of Family and Community Services, July 2000, 33. See generally Tony Blair, *The Third Way: Politics for a New Century* (1998); Gary Wilson, 'Business, State, and Community: "Responsible Risk Takers"', New Labour, and the Governance of Corporate Business' (2000) 27 *Journal of Law and Society* 151.

92 Lindy Edwards, above n 17, asserts this is about the only thing that an economic rationalist policy maker understands. What they have to be shown is that the removal of market imperfections requires government intervention which may be more costly than not having a market in the first place.

93 Mario J Rizzo, 'The Mirage of Efficiency' (1980) 8 *Hofstra Law Review* 641. For a general discussion of the problem of the second best solution see Frederic M Scherer, *Industrial Market Structure and Economic Performance* (2<sup>nd</sup> ed, 1980) 24–9.

94 Stephen King and Rodney Maddock, *Unlocking the Infrastructure: The Reform of Public Utilities in Australia* (1996) ch 4.

of reasoning in a second-best world, resort is made to simple moral choices.<sup>95</sup> And that involves complex ethical debate.

Secondly, to identify imperfections and correct them is the source of the impulse to reconstruct society to fit the theory: reality as represented by empirical investigations represents imperfection that must be fixed. Thus in corporations law, while participants may not conceive of their relationships as discrete transactions, the actions of participants, says the theory, can be so modelled and therefore governed, provided that the transactions are of the appropriate kind. Transactions of the kind envisaged by agency cost assume certain property rights, particular forms of apparent consent and, as we have seen, people of the right kind. In corporations law we see the product of this process: complex, and ironically contract-produced, understandings of the relationships involved are reduced to statuses with rights representing property. Instead of the shareholder being 'an interest measured by a sum of money'<sup>96</sup> but otherwise undefinable,<sup>97</sup> the shareholder is a status provided for in the legislation; the members are no longer the corporation but the product of incorporation. By this process, the share is necessarily commodified. So also for employees, who cease to hold any status within corporations law other than as contracting party, despite the preferences given in s 556 of the *Corporations Act 2001* (Cth).<sup>98</sup>

## D Markets and Coercion

The impulse to correct the imperfections in markets, usually by coercive means, arises in normative economics from the preference for the allegedly non-coercive nature of markets. Yet markets are inherently coercive. Customers have no choice about what price they pay nor producers what price they get, and transactions arise only in the conditions specified: there is defined property about which to transact and it is distributed in a particular way, consent to transactions is expressed in certain ways, and there are institutions, such as law, supporting transactions.<sup>99</sup> These things are created by society and regulation, and no person is free to deny their construction in those ways. This is the essential irony of normative economics: Rousseau's chains bind even in supposedly free markets.

For example, native title was recognised in Australia in the *Mabo Case*.<sup>100</sup> Fairly soon afterwards Parliament dealt with the implications of the recognition of native title in the *Native Title Act 1993* (Cth) ('*Native Title Act*'). This provided a means by which native title could be recognised and many ways by which the interest in land represented by native title could be dealt with by agreement. This latter development established native title as something about which there could be transactions. The question my analysis poses is whether that

95 Schmid, above n 73; Scherer, above n 93, 28–9.

96 *Borland's Trustee v Steel Bros & Co* [1901] 1 Ch 279.

97 *Gambotto v WCP Ltd* (1995) 182 CLR 432.

98 David A Wishart, '2001 in Review: Not the Year for Labour' (2001) 12 *Company and Securities Law Bulletin* 134–7.

99 Andrew K Dragun and Martin P O'Connor, 'Property Rights, Public Choice and Pigovianism' (1993) 16 *Journal of Post Keynesian Economics* 127.

100 *Mabo v Queensland (No 2)* (1992) 175 CLR 1.

which is agreed about in those transactions is the sort of thing the High Court recognised. Did being rendered capable of being the subject matter of agreement fundamentally change native title?<sup>101</sup> Moreover, who are the parties to the agreement? The necessity for parties led to considerable complexity and dispute as the erstwhile basis of aboriginality was challenged and redefined.<sup>102</sup> Indeed, the *Native Title Act* casts parties into the terms of corporation and trust, with all the concomitant decision-making apparatus.<sup>103</sup>

## E Transactions

Markets are a set of transactions more or less narrowly defined. Implicit in this is the idea that the parties to the transaction simply transfer a quantity to settle at a given price. As soon as we step outside the narrow confines of the perfect market (we must not be seduced by that word ‘perfect’ as implying ‘better’), a transaction involves bargaining. This process is virtually ignored in economics. The assumption is that if parties conclude a bargain they are better off than if they had not have entered into it, otherwise they would not have entered into the agreement. The transaction then leads to a Pareto superior world. Yet the reason for the transaction is that one person values what the other has more than that other does and hence pays for it, and the erstwhile possessor gets more than they thought the thing was worth. There are two valuations here – the valuations of each side. And they differ, hence the bargain. But there must be a gap between the two valuations and each party gets a share. Who gets the bigger share? There is some research on the point (some of which was awarded the 2002 Nobel Prize in Economics), usefully summarised by Thomas S Ulen.<sup>104</sup> It establishes that people systematically depart from the predictions of rational actor theory in bargaining situations. This, in law, is the issue of bargaining power. Who gets what is determined by factors outside the bargain. There are implications for the recommendations of normative economics in this: Do we rely on self interest? Do we necessarily bear the cost of market solutions when cooperation might be the norm? And, of course, do we consider the ethic of fairness in distributing the difference between the valuations?

## V SOME APPLICATIONS

The triumph in the (even written) voices of the initial theorists of the firm arose from their perceived breakthrough in subjecting the structure of the firm to positive economic analysis. They felt they had achieved a Kuhnian paradigm

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101 Mark Harris, *The Palimpsest of Native Title* (unpublished PhD thesis, La Trobe University, 2001)

102 See, eg, Elizabeth A Povinelli, ‘The Cunning of Recognition: Real Being and Aboriginal Recognition in Settler Australia’ (1998) 11 *Australian Feminist Law Journal* 3.

103 *Native Title Act 1993* (Cth) Part 11, ss 253, 24CD, 24DE. See generally Christos Mantziaris and David Martin, *Native Title Corporations: A Legal and Anthropological Analysis* (2000).

104 Thomas S Ulen ‘Rational Choice Theory in Law and Economics’ in Bouckaert and de Geest (eds) above n 2, *Vol I The History and Methodology of Law and Economics* (2000) 790, 801–9, <<http://encyclo.findlaw.com/0710book.pdf>> at 20 November 2003.

shift: the firm was amenable to analysis as a series of transactions whereas previously it had been seen as a 'black box' operating in markets. The hierarchy of the firm had been perceived to be the antonym of free market transactions,<sup>105</sup> but now the latter encapsulated the former. This set theorists free to express their preference for less regulation in corporations law. Corporations law becomes just another field for the operation of economic thought. It is for this reason that critique of the economics of corporations law derives from general critiques of economics. In this section, this paper explores how those critiques might work within that field.

The areas chosen are for the purposes of illustration rather than exhaustive exposition. Space, your patience and my ability prevent otherwise. They are from what may be called core corporations law, because it is there that the economics of the firm has its most hidden yet most radical impact.

In all three illustrations there is a common theme. This theme can be encapsulated by the proposition that economics is of the firm, law is of the corporation.<sup>106</sup> Economics may purport to say what the corporation is, but necessarily this is on its own terms. My complaint is that there are a multitude of other ways of understanding the world, and therefore the corporation, and each of these has alternative views on right governance and alternative pictures of what is done in accordance with any other view. In many of these other views what normative economics sees as unexceptionable is untenable in a variety of sometimes surprising ways. This should force the application of the no-waste principles of efficiency into dialectic with other policies in each particular circumstance. This is not to be found in most prescriptions for corporations law from a normative economic perspective. In other words, economics is not necessarily wrong but exclusive belief in it is wrongheaded.

### A Directors

In brief and simplifying somewhat, neo-classical economics of the firm conceptualises directors as agents of capital providers. There is a contract between capital providers and directors dealing with the issues involved in their agency. Performance of directors is generally measured in accounting terms, which most frequently rely for quantification on the markets for what the directors do with the capital. Corporations law intervenes to provide a set of terms for the agency contract which may increase or decrease its transaction costs. These terms frequently deal with shirking, self-enrichment, monitoring and procedures of control. It is relatively easy to attribute sections of the legislation and common law cases to these headings. It is not only corporations law which performs this function: partnership, associations, simple agency and other laws perform the same functions with different emphases.

The agency picture represents an archetype that has to be understood in an environment complicated by many possibilities. If there are a number of capital

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105 Ronald H Coase, 'The Nature of the Firm' (1937) 4 *Economica* 1.

106 Cf Roman Tomasic, James Jackson and Robin Woellner, *Corporations Law: Principles, Policy and Process* (4<sup>th</sup> ed, 2002) 9–10.

providers to a firm, there are difficult issues of expression of preferences. This is resolved, either by law or otherwise, by providing some sort of meeting and voting system, perhaps conceived of as a set of property rights. Where these issues are exceedingly complex, capital provision may be commodified to allow for exit as well as voice: securities markets exist. Collective action games then interpose to disrupt the easy working of systems, these games are compounded by the possibility of the agents also being principals: directors being shareholders. A portion, perhaps even most, of corporations law represents, in this schema, a complex response to these possibilities in the relationship between capital provision and directors.

The claim of this conceptualisation of corporations law is that the upshot of the processes of accommodation to these issues are three markets which impinge on the agency of directors: the product market which measures performance; the labour market (much as directors would dislike the term being applied to them) which dictates terms and conditions of the agency, including remuneration; and the market for corporate control which deals with collective action problems amongst capital providers by converting exit into voice. The history of the development of the mechanisms by which the issues are accommodated is rarely spelled out and, when it has been, there is no consistent story.

There are many possibly normative responses to this picture. One can just wish to make the system work better; one can wish to extend the operation of those markets; or one can wish to make the structure of the system itself subject to the preferences of the actors. Agency cost theory makes all of these possible. While the Simplification Program attempted the first, the last is represented by the debate over the market for legislation and the middle one by attempts to make directors' duties more an internal matter than a prescription either directly or through enhanced exculpation or indemnity provisions. Put this way, a number of the critiques of normative economics can be deployed against the recommendations of agency cost theorists in relation to the law of directors.

Quite obviously, the markets do not work in the way assumed of them. Vast remuneration for directors is so obviously evidence of this that it is not seen as such. Other evidence is overwhelming: Berle and Means' 'self perpetuating oligarchy'<sup>107</sup> is no less true today than in the 1930s. That the Murdoch family can see itself as having dynastic control over empires of wealth surely represents a reversion to genetic understandings of capacity to manage. Brand names survive and marketing overcomes quality: Microsoft dominance, the survival of Corn Flakes, the failure of Sony Beta and a host of other stories testify to these obvious points. But this is exactly the sort of thing a normative economist accepts: their conclusion is, however, that the markets must be made to work better.

If relevant markets are to have an efficient outcome, they have to be comprised of transactions between contracting individuals. The difficulty with markets with respect to the position of directors is that very little about those transactions is at all simple. One party, the corporation itself is, even within the theory, by

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107 Adolf A Berle and Gardiner Means, *The Modern Corporation and Private Property* (revised ed, 1968).

definition an ontological absence and at most a nexus of a whole lot of contracts or property rights.<sup>108</sup> Thus the transactions are only comprehensible metaphorically. What directors do – the stuff of the transaction – is rendered invisible by the theory's insistence that it can only be what is chosen by the parties. However, what directors do is not comprehended by anyone, let alone the parties: it is reasonably easy to demonstrate that risk-taking, entrepreneurial activity, balancing interests of competing interest groups or any other postulated action is not necessarily what is contracted for, and certainly not by any expressed preference. From an economic perspective, it is the complexity and fuzziness of the transaction that permits the abuse of bargaining power – represented by excessive rewards, the siphoning off of wealth and self-selection. If this is so, the environment of the transactions should be repaired, says the normative economist. Critique of that position would assert that transaction and its contents could never be anything but an illusion within the theory; therefore the theory cannot be used to recommend change.

The corporation is but a nexus of contracts or property rights within the theory. As we shall see, that position itself is an untenable basis for recommending change, but even accepting it allows, or suggests, the possibility of directors transacting with themselves. This produces the familiar challenges to the proxy system and the necessity for shareholder protection via derivative actions or exceptions to majority rule, and duties of directors generally. Any attempt to contractualise directors' duties is rightly subjected to the criticism that to do so would be to invite abuse because directors are the ones who write the contracts. Indeed, the application of agency cost theory leads to a contradictory position: on the one hand, the corporation is but a metaphor and, on the other, its position as the contracting party should be enhanced. We see both these positions accepted within law reform in Australia: the derivative action and business judgment rule try to ameliorate the metaphorical nature of the corporation, but the move to a stronger acceptance of legal personality through incorporation by application and a greater reliance on solvency and profit as disciplinary measures is evidence of the second position.

The consideration of contracts is rendered invisible within economics. Transacting individuals are presumed to seek what they want and thereby to satisfy their preferences to the extent of their wealth demands. What their preferences are is not of concern. However, there must be some common understanding of that which is to be agreed.<sup>109</sup> The property or service must be identifiable and transferable: these are the principles of property law and of economic ideas as to property rights. Accordingly, if the service is to be a

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108 Most economics of the firm conceives the corporation as a nexus of contracts. Whincop, above n 12, see especially 209–11, which takes a more sophisticated approach by viewing the idea of legal personality as being deployed for a variety of purposes by courts using analytically quite disparate rules. Yet when it comes to directors, we find ourselves in a variety of roles, for some of which Whincop acknowledges the entity concept is 'problematic'.

109 This is not quite the issue considered by quite a large literature on norms and social conventions: Klein, above n 78, 459–61. But I would suggest that literature is more relevant than a consideration of property, as the latter tends to assume that people know about what they are transacting.

director, what that involves must be the subject of common understanding, howsoever produced. The difficulty is that what being a director involves is not understood. Indeed, the theory itself is founded on a concept of the entrepreneur and this, in turn, is about risk. Transactions themselves are a modality of thinking about the future. Entrepreneurs are those who govern their future by contracting and directors are those who are paid by others to do so with the money of those others. Accordingly, to refer to risk within a recommendation to reduce abuse of the company's capacity to transact is a tautology, because all transacting is about risk. To refer to 'acceptable' risk is an oxymoron because risk is of the unknowable event happening.<sup>110</sup> If the probability of the happening of an event is calculable, there is no risk, merely questions of insurance. There is no way of calculating acceptable in relation to unforeseeable risk. What directors do within economics is accordingly unknowable. Therefore, recommendations as to how to fix the markets in relation to their position are founded on inapplicable premises.

Given that the function of the director is essentially culturally defined, self-selection in the labour market by existing managerial classes becomes probable. Simple fuzziness in the idea will have the same effect. Knowledge and definition of what is apparently required resides with incumbents, and therefore will be defined in their own image. Market processes will enhance existing wealth because the replication of existing individuals reduces supply. Citizenship will be denied because even those with a high preference for being a director are prevented from entering the market by attributes that are impossible to purchase, even were they able to be identified. And directors themselves will increasingly perceive themselves as contracting parties able to negotiate the best deal possible, taking advantage of the gap between the minimum necessary to persuade them to take the position as director, and the maximum available to them from the constrained abilities of those involved in the corporation to make decisions. This maximum itself will vary according to the commonly held preconceptions of what is appropriate for directors to be paid. The world, as was argued above, becomes constructed thus through the self-perceptions of those acting in it. Citizenship is also denied because those in the market for corporate control can only measure performance by reference to an imperfect product market. If the function of directors is defined by reference to the happening of the unpredictable, there can be no measure of performance in predicting it. There is no way of distinguishing the unforeseen and incompetence. Choices are impossible if the criteria of those choices are meant to control directors. The market for corporate control thus necessarily fails and cannot be fixed.

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110 Frank Knight – *Risk, Uncertainty, and Profit* (1921) – distinguished between 'risk', which was for him the probability of future events happening, and 'uncertainty', which was the possibility of complete surprises in the future. I have initially fudged the two here because 'risk-taking', without any such distinction, is a matter which is invariably raised when directors' duties are discussed. It is also a key feature of the definition of entrepreneurship in 'Third Way' literature, which tries to ameliorate economic rationalism. In this context, the idea of risk merely begs the question intended to be solved by the 'Third Way': see Cathy Lowy, 'Is There a Third Way', in Christopher Arup and David Wishart (eds) *Competition Policy with Legal Form* (2002) 20 *Special Issue: Law in Context* 172.

## B Constitutions

The difficulties with a contractual understanding of corporate constitutions are well understood in Australia. Resolutions and their limits are well articulated in law here because that is our system. They are the issues of majority rule and individual rights. The whole is well described by Williamson's 'relational contracting'.<sup>111</sup> The irony of agency theory is that it has been taken to recommend deregulating law reform designed for a system of provided constitutions, and that the process of so doing in Australia has resulted in the development of increased numbers of rules in pursuit of decreased regulation.

It has been repeatedly observed above that discrete and presentiated contracts do not work well in situations characterised by uncertainty and moral hazard. Another way of talking of uncertainty is to refer to the 'bounded rationality' of the individual, and 'opportunism' of moral hazard. The claim of agency theory is that a discrete and presentiated contract can deal with moral hazard, or opportunism, through provisions as to monitoring, control and insurance against default, and that the corporation is one such response.<sup>112</sup> In the contract set represented by the corporation, the substance of the contracts deals with uncertainty. An assumed<sup>113</sup> survival of the fittest in markets in respect of those contracts will ensure lowest cost provision of necessary terms. Compulsory provision of constitutional terms inhibits this process (given that it exists).

The remaking of the corporations into transaction sets involves sets of commonly held concepts about those transactions. These are as to the parties, content, procedures of consent and place of law. Each of those sets of concepts in relation to corporations law is uncertain. The corporation as party is a mere metaphor, those involved in corporations may not adhere to particular rationalities necessary for choosing, and corporations are about uncertainty – these factors all militate against a feasible simplification. The problem is that the epistemology of economics forces a simplification and narrowing of the ideas behind corporations law: stuff is left out. This includes what a director does, what a shareholder is, how authority translates into corporate acts, how employees relate to the corporation and why they are preferred, and so forth. In so far as a policy forces change away from some sense of ontological existence, or some set of commonly held precepts, it is coercive even if it is not inefficient within the very terms of neo-classical economics. The homogenisation of corporate structures into profit-making companies – as fits the theory – denies the possibility of other forms of relating; the contractualisation of our subjectivities denies forms of existence based in other grounds than self-interest, and society will be vastly the poorer for the removal of other forms of relating – both at institutional and personal levels.

There is also the deep ethical question, illustrated by a problem in philosophy.

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111 See, eg, Oliver Williamson, 'The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting' (1985).

112 Michael C Jensen and William Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

113 See text accompanying nn 82–6.

It is appropriately called the problem of ‘agency’.<sup>114</sup> It is characterised by the following scenario. You have given another person the authority to terminate your life on the happening of a certain event. You express that agency to be irrevocable. The event happens, and your agent comes to carry out their duty. You purport to revoke their authority. Can you, or will you die? In *Gambotto v WCP Ltd*<sup>115</sup> Mr Gambotto purchased a relatively small number of shares in WCP Ltd. The then *Corporations Law* conferred upon a special majority the right to alter the constitution of the company<sup>116</sup> and WCP Ltd’s constitution did not qualify that right. The majority passed a special resolution altering the constitution to allow for the expropriation of shares. Mr Gambotto’s claim was that his agreement to the constitution did not extend to expropriation, despite no exclusion of authority. Whatever your view of the decision, the case itself demonstrates that contracting when you do not know what is going to happen has been held in law to have limits. It also demonstrates minority rights and, conversely, majority rights to overrule the constitution. At what point and in what respects – in binding yourself to others for the future – can you repudiate that bond? This is a question about the very freedom that normative economics is about. There is no reason to prefer any solution over one already arrived at.

### C Personality

This, ‘in agency’ cost theory, is the nexus of contracts and perhaps property rights. It could not be otherwise from the utilitarian perspective.<sup>117</sup> And, of course, the critiques of that perspective apply, as demonstrated above.

In so far as law constitutes society, representing that structuration in which individuals act other than as consumers, to move law to the nexus view is to deny the function of law. Corporations law is one of the few remaining recognitions of group life independent of the state, a recognition which agency theory denies. A genealogy of this development could start with *Sutton’s Hospital*<sup>118</sup> in the seventeenth century, when Lord Coke stated the corporation to be an artificial being existing only in the eye of the law. Lord Coke set the scene for liberalism by constituting the human being as the subject of regulation, rather than the corporation or other institution. This left the corporation as a subject of law, agency cost theory extending that process by rendering invisible any alternative construction of individuals and the way they act – even in corporations. In changing the law to work on the basis of agency cost theory one of the bastions of group life is removed. As the discourse of neo-liberalism is internalised, so people reconstruct themselves to govern themselves as contracting individuals, with concomitant loss of relational capacity.

The application of the nexus of contracts view uses the ethic of efficiency to legitimise the existence of the corporation as a legal person. Yet, as we have

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114 I am grateful to my colleague Cathy Lowy for bringing this to my attention.

115 (1995) 182 CLR 432.

116 This is one of the oldest sections in company legislation, and now appears in the *Corporations Act 2001* (Cth) s 136(2).

117 Wishart, above n 31.

118 (1612) 10 Co Rep 23a; (1613) 77 ER 960.

seen, the ethic of efficiency says nothing about redistribution. This is in contrast to other discourses that make reference to alternative value systems. If the corporation is justified along republican lines, the existence of limited liability is intensely debated. This is what happened in relation to Lowe's vision of the company in the nineteenth century.<sup>119</sup> But as a nexus of contracts, limitation of liability is a matter of risk shifting – legitimised by the implicit consent of creditors. However, the contract between the directors and capital providers affects third parties coercively if that consent is missing. Courts construct consent,<sup>120</sup> yet in agency theory such a construction is assumed thereby – effecting compulsory redistribution.

## VI CONCLUSION

This essay began with an exploration of four aspects of economics of relevance to corporations law. They were its epistemology, the way economics deals with law, the idea of the individual human being and the meaning of markets. From these considerations an extensive list of shortcomings of economics in this context can be distilled. To be able to do so was perhaps the chief object of the exercise.

If you wish to argue against a recommendation arising out of normative economics (or law and economics), particularly in the field of corporations law, the following is a shopping list, in no particular order:

- the epistemology of law and economics is flawed;
- the ethics of efficiency are insufficient;
- the citizenship of its politics are exclusionary;
- the distribution of wealth is neglected, if not ignored – to put this another way, it reifies the status quo;
- the proselytisation of economics constructs people to be inimical to society;
- as a science of choice it has a simplistic idea of choosing;
- as an incomplete description of society the problem of second best deprives it of normative utility;

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119 Paddy W Ireland, 'The Rise of the Limited Liability Company' (1984) 12 *International Journal of the Sociology of Law* 12; G R Rubin, 'Aron Salomon and His Circle' in John Adams (ed), *Essays for Clive Schmitthoff* (1983) 99.

120 Constructive knowledge is an example, although it is now abolished: *Corporations Act 2001* (Cth) s 130. The situation of the unintentional creditor, such as a tortfeasor, causes considerable difficulty such as in the Bhopal cases (see Jamie Cassells, *The Uncertain Promise of Law: Lessons from Bhopal* (1993)) or the asbestosis case, *Briggs v James Hardie* (1989) 7 ACLC 841, where isolation of liability in one member of a group of companies effectively denied compensation. A half-way position is represented by the New Zealand case of *Trevor Ivory Ltd v Anderson* [1992] 2 NZLR 517, where the fact of registration was taken to give notice that advice given was given by the company and, therefore, any negligence in giving the advice was the company's alone – and not that of the person giving the advice.

- its preference for markets is a mere bias – to put this another way, markets are as necessarily flawed as politics;
- its core concept of transaction is unworkable;
- as a utopian project, implementation fails in the exigencies of society's present state; and
- measurement of whether indeed what is done has the desired effects is susceptible to being contingent on the theory's own premises.

By way of exemplifying the use to which this list can be put, the essay proceeded to apply many of the criticisms to three areas of application of economics to corporations law. These are the law as to directors, corporate constitutions and legal personality. Many failings were identified, but chief among them was the poverty of tenable recommendations both as practical measures and ethically.

Despite all this, economics is one of a number of useful, but inevitably flawed, ways of theorising about society. It has the virtue of telling us some of the things that might happen if we do something. In its normative form, economics recommends on certain ethical premises. These are founded on the notion of efficiency: putting society's resources to their best possible uses where 'best' is defined by what individuals want. While this must be constrained as a complete ethical vision, it is undeniably an acceptable one (amongst many). What, then, can we use the economics of the firm for? Rational actor theory and hence efficiency are perhaps appropriately deployed in thinking about business, although that does not legitimate an extension of business into areas operating on more associative, even altruistic, norms and values. Moreover, corporations law itself is not exclusively about business. In juggling these issues perhaps the most we can say is that the recommendations of neo-classical normative economics should be deployed only when it is decided that its ethical premises are the appropriate ones in the circumstances. But, then, how is this to be decided?