

4. Special Interests, Competition, and the Rule of Law

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Consider one day's headlines on legal topics drawn from the *Wall Street Journal*:

1. *FDA Nears Rule Shift on Food Ingredients* concerns a regulation 17 years in the making that concerns “ingredients used to thicken, preserve and flavor foods” (Tracy, 2014: A3). Self-declared “public interest” groups have sued, contending that the agency’s notion of ingredients not subject to FDA regulation because “generally recognized as safe” is unsound. “The public deserves” that the FDA provide more “regulatory scrutiny over food additives”.
2. *EU Official Decries Google Pressure* details a four-year probe by the European Union “competition commissioner” into Google’s “manipulation” of search results (Fairless, 2014: B1). The commissioner explains that European politicians are concerned that European companies cannot keep pace with Google and, to add to the burdens of the antitrust officers, they have been “unearthing” Google’s use of differential tax rates in different jurisdictions.
3. *OSHA Takes Aim at Dollar Tree* notes that the retail discount chain has been subject to \$866,000 in fines during the past year, including \$262,500 in fines for violations at one store in Watauga, Texas (Berzon and Ziobro, 2014: B2). The agency head explained that across the country each “store has some serious hazards”. Hazards included boxes stacked too high and blocked electrical panels. No injuries have been reported but workers could have been injured.

4. *Board Backs Access to a Pricey Drug* explains that the Arkansas Drug Utilization Review Board recommended the state's Medicaid program end a legal battle by allowing use of a costly drug (more than \$300,000 a year) called *Kalydeco* that treats cystic fibrosis (Walker, 2014: B2). Federal law requires drug makers to provide at least a 23.1% discount to Medicaid beneficiaries.

5. *Disabled-Access Lawsuits Surge* reports thousands of suits being filed against small businesses in the past year for violations of federal disability law that mandates accessibility requirements (Loten, 2014b: B4). For example, a thousand-square-foot hotdog eatery in Miami was cited for 30 violations. Lawsuits have risen sharply as "testers" are now used to look for violations as the basis of suit. Under federal law, defendants may be required to implement physical modifications and, while plaintiffs cannot sue for damages, the defendant pays legal expenses of both sides.

6. *Accessibility Claims Expected over Websites* is a companion article predicting a new crop of suits contending that websites, including apps, lack adequate access for persons with disabilities (Loten, 2014a: B4). The Department of Justice settled an accessibility suit with H&R Block and, in doing so, provided a "road map" for disability claims against websites that lack proper captions, text alternatives, and audio descriptions. Potentially hundreds of thousands of website and app providers could be at risk.

7. *Trial Turns to "Secrecy" at UBS* reports on the day's court proceedings in a Justice Department suit against a Swiss national who worked in Switzerland partly for American clients (Grossman, 2014b: C3). He was accused of abetting US income tax evasion by the use of, naturally, Swiss bank accounts.¹

8. *Mortgage Rules Move Closer to Final Form* discusses the three-year process to finalize "long-delayed mortgage-market standards" as the Federal Reserve and five other regulatory agencies exercise powers expanded by the Dodd-Frank law of 2010 (Zibel and Ackerman, 2014: C3). The new rules will, regulators assure, prevent "a repeat of the 2008 financial crisis".

1. Three weeks later the jury took less than an hour to acquit the defendant (Grossman, 2014a: C1).

Other articles in the *Wall Street Journal* that day noted other legal matters, but the preceding articles illustrate the domination of legal matters by regulations aimed at exerting public control over private behavior (Gershman, 2014: A6). These regulatory efforts are allegedly focused on preventing bad consequences of private actors' behavior. None are aimed at increasing the production of wealth by facilitating the creation of businesses or making it cheaper to conduct transactions. The best-case scenario for such regulations is that they will cost less to implement than the costs of the harms they avoid. Today this is how many people conceive of the role of law—to reduce or prevent bad consequences.

But there is another, and more important, role for the law: to facilitate the creation of wealth by making it easier and cheaper for people to engage in economic activity by organizing entities and conducting transactions. For example, when a government sets out clear default rules to govern the internal affairs of a business entity, it makes it less costly for investors to form such entities. That in turn expands commerce and increases wealth. Similarly, by establishing laws that facilitate contracting, the state can lower the cost of creating a contract.

Those were the concerns of much of the legal system until the Progressive Era began the expansion of the regulatory state and the crowding out of wealth-increasing laws by focusing on loss-avoiding regulatory activity. Similar efforts are key to justification of much legislation today. They create opportunities for special interests to use the legal system to gain unfair advantages over the public.

How to get “good law” puzzles legal scholars. Most academics (and probably most people) believe that we know it when we see it but why some jurisdictions have legal regimes that are generally regarded as supportive of personal and economic freedom, and others do not, is not clear. The larger puzzle is beyond our scope; here we discuss some features consistent with an economically productive rule of law and some reasons that defects arise in legal regimes.

The growth of the regulatory state

The primary beneficiaries of a focus on loss-avoiding regulatory activities are lawyers, bureaucrats, special interests in the private sector, and politicians. Those groups are the ones that know best how to manipulate the political agenda that receives broad support. These interests frame efforts to benefit themselves as public-spirited regulations. The news stories above can be recast as: protecting the public from poisons in food, protecting completion from a predatory monopolist, protecting employees from unsafe working conditions, allowing those afflicted with terrible

diseases to have access to over-priced drugs, providing disabled persons the dignity of access to restaurants and other services that non-disabled persons enjoy, ensuring that all taxpayers pay their fair share, and preventing rapacious bankers from visiting another financial catastrophe on the nation. How one frames an issue counts for a great deal.

The role of lawyers

“Too many lawyers” is a common claim, yet the market for legal services shows signs of both oversupply of lawyers and undersupply of the services (Koppel, 2014: B3). Signs suggest the market for legal services is being disrupted by new businesses that provide services using technology, systems engineering, and business methods (Susskind, 2008, 2013). Lawyers can play crucial roles as “transaction cost engineers” or they can gum up transactions with efforts to block competition. Rather than attack the legal profession as a whole, as some have, we focus on legislatures’ responsibility for this state of affairs. There is no doubt that it is also a result of action by bureaucracies, but solving the problem starts at the legislature.

By way of full disclosure, it should be noted that we work for state universities and, in previous careers, worked for regulatory agencies—that makes us bureaucrats. And we are both lawyers. Like our colleagues now and those in other government agencies, we are hired help. We follow and enforce rules and budgets set by legislators. We have some discretion but have no doubt that if we charge off in some non-sanctioned direction to achieve what we think would be greater glory, our employers would quickly rein us in.

Bureaucrats are not unconstrained free agents who invent rules and spend public money without oversight. Indeed, on the occasions when they attempt to do so, legislatures take action. For example, disgraced, former Illinois Governor Rod Blagojevich was impeached not only for his efforts to trade an appointment to the US Senate and other official acts for favors and contributions, but also for efforts to create a regulatory program and spend state money without legislative approval (Illinois House of Representatives).

It is important to focus on legislatures. While bureaucrats have some degrees of freedom, agencies exist because they are delegated authority to act by legislators, who often then disclaim responsibility for the costs of the resulting regulations. The key point is that, while bureaucrats may push the mission of their agency and will plead for bigger budgets and more authority, agencies’ actions ultimately require legislative and administrative consent.

Legislators and special interests

After the election in 2014, when the Republicans recaptured control of the US Senate, there was discussion in media that the election results would produce change in many areas of federal regulation. However, as the next chapter documents, regardless of how dramatic election outcomes may appear to be, the regulatory state has grown continuously for decades. There are fits and starts, but the regulatory state never shrinks. This is not because the bureaucrats are out of control but because Congress and the President have not seen fit to roll back the regulatory state, occasional election rhetoric aside. Nor is it because it is impossible, as the rare successful deregulatory initiatives demonstrate (Stansel and McMahan, 2013: table 2.1b). In the 1970s, the commercial aviation, trains, trucking, telecommunications, and natural gas industries all were significantly (but not entirely) deregulated under the Carter and Reagan administrations. But in most areas of the economy and in our personal lives, legislative intervention generally expands, often eroding freedom and the rule of law.

Public Choice, a field largely invented by Nobel laureate James Buchanan and his colleague Gordon Tullock, is often called politics without romance (Buchanan and Tullock, 1962). Applying economic logic to the political arena allows the rose-colored political glasses to come off. We then see the political process more clearly by focusing on the incentives of participants in politics. Just as companies peddle products by advertising the benefits and ignoring the shortcomings, politicians sell themselves and their ideas in a highly competitive arena for votes and, then, political power.

The essence of Public Choice can be summarized briefly. Running for office requires garnering positive publicity, financial support, and votes. Issues must be framed in a way palatable to a potential majority of voters. Yet voters are rationally ignorant about most political issues: information is costly, there are hundreds of issues, and to become knowledgeable about all would take an immense amount of time, so voters focus on a few issues they care about, whether financial, such as support for teachers' unions, or non-financial, such as abortion. Even voters well informed about a specific issue generally know little about the nuances of candidates' views, even if the candidate has been in office and has an extensive record.

The sugar subsidy is often used in teaching principles of economics to illustrate economic damages when government subsidizes a domestic industry (Wohlgenant, 2014). Students are irritated to learn of the seeming foolishness and may ask why Congress allows this to go on, decade after decade. The answer is

concentrated benefits and dispersed cost. Each American household chips in about \$10 a year to sweeten the pot for domestic sugar producers. It is hard for an individual voter to get excited about a few bucks when other political policies mean so much more. Few of us know how our representatives vote on most issues—unless we are recipients of the benefits (and such measures are frequently buried in complex legislation). Congressional representatives from the few southern states where sugar cane is grown, and the few northern states where sugar beets are grown, pay close attention to this issue because sugar growers care a lot as they reap the benefits.

Sugar-grower representatives ensure continued support for sugar subsidies by trading votes in Congress (“logrolling”) for, say, urban mass transit support that benefits this or that city but is of no value to sugar beet farmers in North Dakota who chip in for the transit subsidy. More is involved than just handing over money to sugar growers. Subsidies and regulations have complex results. For example, Chicago used to be a major candy-making center. No more. Pricy US sugar drove many candy makers out of the country (Lydersen, 2006). The sugar subsidy is surely not responsible for industrial decline in the Midwest, as a single nick in an economy matters little. However, make that a thousand nicks and the total damage is immense.

Politicians routinely claim they will not support legislation for special interests. But, if true, they are unlikely get to Congress or the state legislature, are ineffective if they get there, and generally do not last long in politics. It tends to be a winning strategy to rail against special interests but support the causes not branded as special interests that matter to your constituents.

Federal regulation of industry began on a large scale with regulation of the railroads. Mid-western farmers claimed that prices to carry grain to eastern markets were too high. Agricultural interests thought they had won a victory with the creation of the Interstate Commerce Commission (ICC). However, contrary to the expectations of agrarian interests, the agency was soon dominated by the industry it was presumed to control (Kolko, 1965). Farmers did not dominate the ICC, experienced railroad people did. An economist, viewing the same episode, documented that the railroads wanted the ICC as a way to have government protection for cartelization of the industry (Hilton, 1966). This is referred to as regulatory capture. Whether an industry originally seeks regulation or not, it has strong incentives to gain a strong position in the details of the regulation. Capture is possible because the public remains rationally ignorant of the intricate details of regulatory schemes.

Other times, moral crusades have political impact. Alcohol was illegal in the United States during Prohibition (thereby greatly benefiting Canadian alcohol vendors and Bahamian rum runners). Some alcohol vendors learned to benefit from the controls. Bruce Yandle first explained this in a landmark article that noted that bootleggers profit from the prohibition of the legal sale of alcohol and want restrictions to continue (Yandle, 1983; Smith and Yandle, 2014).

In more recent times, the moral and health crusade against tobacco products has produced numerous regulations on such products over the past 50 years. Seeing the threat, the industry played an active role in crafting regulations that have allowed the major cigarette makers to continue profitable existences in the face of less competition (Yandle, Rotondi, Morriss, and Dorchak, 2008). Politicians can play both sides of the issue—talking tough to the delight of those who wish tobacco to be prohibited while catering to the interests of the tobacco makers.

Legislators need not even engage in actual regulation; even the *threat* of regulation can benefit them. That is, legislators can credibly threaten to impose costly regulations on an industry. They gain the virtue of appearing to protect voters from misbegotten deeds of rapacious business practices, while bringing business interests running in the form of contributions. Professor Fred McChesney explains this as “Money for Nothing” (McChesney, 1997). While this may be seen as near extortion—contribute enough and we call off the regulatory dogs—it is legal and bolsters campaign coffers.

Of course, legislative interventions are necessary to control some problems. Few question the need for national defense, a judiciary, basic principles of tort, property, and commercial law, and other sensible roles for governments. There is an important role for the law in facilitating private transactions. For example, the Uniform Commercial Code, a version of a statute enacted in whole or in part by every US jurisdiction, draws upon long-established mercantile practice to facilitate commerce by providing sensible default rules to govern many aspects of business transactions (Mentschikoff, 1950; Kamp, 2001). Doing so enables businesses to spend less on drafting agreements, making the cost of transactions lower.

Similarly, states provide default rules to solve internal governance problems for business entities such as partnerships, corporations, and LLCs. These laws enable people to create business entities at lower cost, facilitating commerce. Tort law principles govern interactions between strangers where one party causes harm to another. Property law specifies the parameters of ownership and provides mechanisms through which ownership of assets can be verified cheaply, facilitating

trading those interests. But we have gone far beyond the provision of ordinary public services expected of a government. Today we face a bewildering array of laws and attendant regulations that are incredibly complex. Regardless of the rationales for passage of the kinds of statutes that lead to the types of headlines noted at the start of this chapter, their existence means that it is ever more difficult to start and manage a business.

The challenge for governments is to find a balance between creating laws and regulations that facilitate the creation of wealth and protect persons and property from harm and laws that impose costs on one group to benefit another and reduce net wealth. Regulation can impede economic growth rather than facilitating it. For example, Google and Amazon have run up against regulatory barriers in the development of commercial drones. They have moved work to Australia, citing less severe regulatory environment there (Stewart, 2014). How then to get things done in the United States? Google “has hired a lobbyist firm to influence policy-makers to clear the path forward” (Neal, 2014). In the meantime, a Chinese firm has become the leader in the drone market (Nicas and Murphy, 2014: B3). When more roadblocks for new business developments exist in the United States than in China, something is amiss.

Historical roots

Regulatory states with broad powers do not appear overnight in functioning democracies—they evolve over time. In the United States, the seeds planted in the Progressive Era, which began with railroad regulation, bore fruit during the Great Depression, when the Roosevelt Administration and Congress turned to government to solve additional problems. The federal government enacted regulatory measures in the belief that increased regulatory control could lead to prosperity by reducing the bad effects of the Depression.

For example, the National Industrial Recovery Act (NIRA), passed in 1933, created the National Recovery Administration (NRA). The NRA’s job was to establish codes for every industry under which markets would be divided among firms that agreed, with government oversight, to have “fair competition”. In practice, that meant government-approved prices and wages and restrictions on the means by which firms could compete. In short, it established government-sanctioned cartels to organize every major industry in the United States. “Unscientific” price-cutting competition would be set aside in favor of a closely regulated industrial structure. The NRA quickly issued thousands of regulations, many of which were actually

written by the affected industries themselves. This was a dramatic change in the role of the legal system, which had previously focused on facilitating voluntary transactions except when they were agreements in restraint of trade.²

Another New Deal regulation further illustrates how far such controls could go, as they still do today. The Agricultural Adjustment Act (AAA) of 1933 imposed detailed controls on agriculture, along similar lines to the NIRA's approach to manufacturing. Although held unconstitutional in part by the Supreme Court in 1936, Congress passed a new version that was almost as far reaching as the first version (*United States v. Butler*). This second version was challenged as well. The facts of this case are worth examining to illustrate the key difference between transaction-facilitating law and loss-avoidance laws.

Roscoe Filburn was born to a farm family in Ohio and made his living on his 95 acres, selling milk and eggs (Chen, 2009). Filburn also planted wheat, some of which he sold, some of which his family ate, and much of which was fed to his livestock. Under the terms of the second (1938) version of AAA, Filburn was told he could plant just 11.1 acres in wheat. Instead, he planted 23 acres and harvested 239 bushels of wheat more than his share of the federal quota. When agents of the United States Department of Agriculture discovered the extra acreage, Filburn was ordered to pay a penalty of \$117.11, 49¢ for each extra bushel grown without authorization. The Supreme Court upheld the controls on planting limits and the fines imposed on lawbreakers (*Wickard v. Filburn*). Although Filburn argued that, because the wheat he grew was consumed on his own farm, it had not been sold in commerce, the Court found that “consumption of homegrown wheat” affected interstate commerce since his homegrown wheat substituted for wheat he would have bought in the market had he not grown his own: “That [Filburn’s] contribution to the demand for wheat may be trivial by itself is not enough to remove him from the scope of federal regulation”. Mr. Filburn alone does not matter, but let many farmers act similarly and there would be an impact on the wheat market. The Court found this sufficient to justify regulation of Filburn’s private wheat patch grown for his own consumption.

In practice, *Filburn* means that Congress can regulate commerce down to the smallest level. The Commerce Clause says Congress may regulate only commerce

2. The Supreme Court struck down the NRA codes in 1935 as beyond the constitutional power of the federal government to regulate interstate commerce, which had been the asserted basis for the NIRA (Schechter, 1935).

that is interstate, but because the actions of individual actors within a state can, in the aggregate, affect interstate commerce, regulatory powers over business are nearly unlimited. In the decades that have passed since *Filburn*, Congress has not been shy about imposing detailed national regulations on business. The Supreme Court cited *Filburn* as part of the justification for the federal ban on medical marijuana, even if grown for personal use (*Gonzales v. Raich*). As these regulations are layered upon one another, the result has been increasing legal complexity, which is itself an important cost.

Legal complexity

Some legal matters are unavoidably complex. Later we will review some complex areas of law that provide competitive benefits, where the complexity is required by the nature of the issues addressed. However, regulatory regimes are often complex for non-productive reasons, which deters economic activity. This complexity can be by design, to reduce competition by raising the cost of attempting to compete. Professor Peter Shuck argues that complexity is costly, is increasing, and does not result in greater justice (Schuck, 1992). Shuck's framework is useful for thinking about the structural legal problem we face in a system of ever-increasing rules. He argues that complexity has four dimensions: density, technicality, differentiation, and indeterminacy or uncertainty.

Dense rules

Dense rules are numerous and cover in detail certain kinds of behavior and transactions. Specific terminology is important and permission is often required from authorities. Schuck gives the example of pension law. Any one who has looked into the Employee Retirement Income Security Act of 1974 (ERISA) realizes that you either become an expert in the field or are a danger to yourself and others. Dense rules reduce transactions by raising the level of investment necessary to determine whether a transaction is permitted.

Technical rules

Technical rules require expertise to understand and use, so ordinary citizens (that is, anyone but an expert) rarely can comprehend them. The Internal Revenue Code is a prime example: interpreting the tax code requires special expertise and knowledge of a bewildering array of regulations, revenue rulings, and other material in addition to the statutory language. (The Code is also dense as it runs to

18,000 pages.) Technical rules impede economic activity by raising the cost of complying with them when engaged in economic transactions. On the margin, there will be fewer such transactions as a result.

Differentiated rules

Differentiated rules occur when an area is subject to multiple sources of legal constraints. Schuck illustrates the issue in the case of product safety—there are multiple federal and state laws, standards issued by private organizations, and provisions of tort and contract law. The same is true of some areas of property law—there are overlapping federal, state, and local rules that apply to particular properties on everything from historic preservation (generally trying to prevent changes to buildings) to disability access (generally requiring changes to make buildings more accessible). Adding differentiation to a regulatory effort can make the rules more accurate, but it can also raise the cost of engaging in economic activity, as actors must determine, for each transaction, which rules apply (Morriss and Dudley, 2006).

Uncertain (or indeterminate) rules

Uncertain (or indeterminate) rules are flexible rules and institutions that can be difficult to define and are often determined in practice by the facts of the particular matter at hand. In torts, the “reasonable person” standard governs in negligence. What is “reasonable” depends on the circumstances, making predictable application of the rule in advance difficult. This can be true for administratively issued regulations as well—efforts to distinguish “abusive” tax shelters from legitimate tax avoidance raise the same type of questions.

The complexity problem is especially salient when Congress or a state legislature grants authority to a bureaucracy to regulate an issue. The bureau responds with dense and technical regulations. Despite all the detail, agencies retain significant discretion in deciding which rules will be enforced, when they will be enforced, and against whom they will be enforced. That is, the rules are, despite their density, still uncertain and differentiated in terms of who will run afoul of them.

Prior to the New Deal, Schuck notes, most matters among private parties were largely governed by private law. Since then, an explosion of legislation has greatly expanded administrative rules to cover many aspects of business and people’s conduct of their private lives. Administrators and judges, interpreting statutes

and regulations, frequently have significant discretion in applying these rules. That results in uncertainty. This in turn means people face greater costs in conducting transactions and organizing their lives.

Are we, short of a wholesale legal revolution, doomed to live in a world of ever expanding and intrusive law? Schuck's categorization of the current legal regime is instructive and illustrates much that is wrong. However, not all legal complexity need be wasteful or held in suspicion. As we develop next, complex legal regimes appear to be necessary for the functioning of certain markets and are, therefore, beneficial. Why they arise in some places and not others deserves attention.

Competition in law

In the same way that competition among market actors lowers costs and prices, increases variety, and improves quality, so too does legal competition among jurisdictions. Just as jurisdictions compete to attract economic activity to their territories, they can use their legal systems to enhance their competitive positions. Competition among jurisdictions within a country, where subnational jurisdictions can compete, as in Canada and the United States, and across countries provides incentives for legislators to constrain their natural desire to exploit their power to impose more legal controls that serve to make them and their positions more valuable.

The result of competition is seen in the Fraser Institute's *Economic Freedom of the World* (Gwartney, Lawson, and Hall, 2014). More wealth is created in countries with less wealth-destroying, transaction-inhibiting law. Even within countries, legal competition provides benefits. Residents of Saskatchewan enjoy more freedom than do residents of Quebec, just as residents of Florida enjoy more freedom than do residents of New York. National governments sometimes allow competition within their borders. For example, in Canada and the United States, provincial and state governments, and cities within those jurisdictions, have the ability to differentiate themselves in taxes and regulation. Personal income-tax rates in Alberta are capped at 10% while they rise to 21% in Nova Scotia (Canada Revenue Agency, 2014). In New York, an average of 12.6% of personal income goes to state and local taxes while it is 7.5% in Texas (Tax Foundation, 2014). Alberta has greater labor-market freedom than does Prince Edward Island; North Carolina has greater labor-market freedom than does New Mexico (Stansel and McMahon, 2013).

Subnational governments can make themselves more attractive to residents and businesses. Firms do not leave California for Texas in search of better scenery

or weather: it is sometimes to take advantage of a less burdensome tax and regulatory environment. How a state can make itself attractive for business opportunities is illustrated by the case of Delaware as the most favored location for firm incorporation. Designing legislation in response to business can be catering to special interests. However, Delaware's story is one of responding to substantive business reasons, not because there has been a "race to the bottom" to get away with looting shareholders or lining the pockets of legislators.

Corporate law

At one time New Jersey was the dominant state for incorporation, which is a matter of state, not federal, law (Yablon, 2007). But New Jersey damaged its reputation for consistent, reliable law by making major changes in its corporate law in 1913 that restricted businesses ability to organize as their owners saw fit. Delaware responded by adopting the pre-1913 New Jersey law and accepting as binding prior New Jersey precedent interpreting it. Delaware effectively promised that it would respect the interests of the users of corporate law and not make the law a matter of political whim. Delaware located the interpretation of its corporate law in the Court of Chancery, where there were no juries, and soon developed a reputation for appointing only particularly knowledgeable judges to that court. Not only did this promote legal stability, but it ensured that the law could adapt to meet future needs. As firms moved their state of incorporation (which does not require a firm to have a physical presence in the chosen state) to Delaware, the state began to benefit from having the best corporate law. Thousands of firms pay annual registration fees and Delaware attorneys and corporate services companies earn fees representing the firms that select Delaware as their corporate home.

Because Delaware offers high-quality law in the corporate area, the state earns significant revenue that accounts for about 25% to 30% of the state budget (Bainbridge, 2014; Wayne, 2012). In effect, this fiscal dependence serves as a "bond" for Delaware's continued adherence to its side of the bargain. If Delaware began to behave badly by changing the law in foolish ways, companies could easily change their state of incorporation. That this would dramatically reduce state revenues gives Delaware's legislators and judges an incentive to ensure that they are not perceived to have reneged on the bargain. By contrast, revenues from corporate fees make up a tiny fraction of the California state budget, giving that state's legislators and courts little reason to care if the owners of California businesses find the state's laws governing business organizations unhelpful. Not surprisingly, more Fortune

500 companies are incorporated in Delaware than in any other state. Analyses of stock-price changes following the move of a corporation's domicile to Delaware generally find that the price of the stock increases after the move—a sign that investors approve of the governance solutions provided by Delaware law. The fact that other states can offer to provide quality law and legal services in that area disciplines the legislature in Delaware from renegeing and attempting to extract revenue from firms.

Similarly, as limited liability companies (LLCs) have become popular, states competed to be attractive places for registration of this organizational form of business. Although LLCs were first given legal status in the United States by legislation in Wyoming in 1977, the form quickly spread to other states, which developed market niches that lured LLC owners to use their states. Nevada has emerged as a significant state for LLC organization. The Nevada LLC statute emphasizes flexibility, low fees, and provides specialized courts to handle disputes related to LLCs. Having gained a reputation for good law in this area, Nevada has little incentive to debase the law as its LLCs can migrate their legal home elsewhere and other states know that to compete for more business registrations they must offer quality business law and courts.

International competition for financial services

We generally think of regulation as stifling competition, but competition among regulatory regimes can produce higher quality regulation that is attractive to business interests. A few decades ago the market for international debt securities was less than a trillion dollars. Today it is tens of trillions as money moves globally to seek the best opportunity. Tariffs and other trade restrictions have generally been reduced through GATT and WTO agreements, which also spurred investment in other nations. Governments that resist free trade and integration into the global economy deny better lives for their citizens, North Korea being the sickly poster boy for a lack of economic openness.

As the number of countries expands (the UN began with 51 members and now has 193), the number of competitors for capital has increased. Government leaders do not always want investment for the betterment of the populace. Leaders may intend to expropriate wealth, or decide to do so once it appears, but investors understand this reality and make choices based on evaluation of risks. Invest in Switzerland and the chance of government expropriation (either directly or through inflation) is low; invest in the Central African Republic or Venezuela and the chance of expropriation is high. Improve the investment climate, as China

and Chile have done over the last 30 years, and more cash flows in to create jobs and wealth. How to get government leaders to behave and not steal is the great unknown in economic development but, in general, competition for capital has meant gradual improvements in economic freedom around the world. People, like capital, migrate to where there are opportunities.

Countries have different comparative advantages. Remote places with small populations are unlikely to be competitive locations to build cars, but they can become attractive locales to produce goods that do not require a large labor pool, such as financial services. Since World War II, a number of small jurisdictions with few alternatives learned how to develop regulatory and legal regimes that would lure international financial services business.

For example, the Netherlands Antilles, a Dutch colony in the Caribbean near Venezuela, was one of the first to create a legal regime specifically designed to attract international investment. By the 1970s, it had a role as the jurisdiction that facilitated US companies tapping into the growing “Eurodollar” market of US dollars outside the United States, enabling these firms to reduce their capital costs significantly. How did a tiny Dutch territory become the preferred location for issuing US corporate bonds?

It was the result of a combination of an entrepreneur, notary Anton Smeets, and some historical accidents that created an opportunity that Smeets was clever enough to seize (Morriss, 2010). When oil was discovered in Venezuela in the early twentieth century, the Anglo-Dutch refiner Royal Dutch/Shell was eager to exploit the oil field but reluctant build an expensive refinery operation in unstable Venezuela. Close to the Venezuelan coast, the islands of Curacao and Aruba offered excellent natural harbors and the stability of Dutch law. Oil companies like Royal Dutch/Shell built their refineries on those islands and brought crude oil from Venezuelan fields to the islands. This arrangement necessitated the development of a professional workforce of accountants, lawyers, and notaries (an important profession in civil law systems such as the Netherlands’) to help administer the refining companies and the other firms that grew up around them. When German armies massed on the Dutch border early in World War II, the Dutch multinationals wanted to safeguard their international assets from the Nazis. If the companies remained headquartered in the Netherlands, the Germans would acquire ownership by making Dutch shareholders an offer they could not refuse, giving the Nazis title to extensive assets around the world in neutral countries. (The Germans did indeed manage to acquire, at a substantial discount, many Dutch businesses after the invasion.)

Under Dutch law, the legal “seat” of the corporations (the civil law equivalent of the state of incorporation under US law) could be cheaply and quickly relocated to other parts of the Kingdom of the Netherlands. Anton Smeets proposed to manage the legal affairs of companies that chose to relocate their legal seats to Curacao and many Dutch multinationals accepted. Smeets formed a firm to do so, CITCO, which continues to be a global leader in the corporate services market. As a result, a vibrant business in managing the legal affairs of Dutch companies developed on the island during the war years.

After the war, many multinationals returned to the Netherlands, but the infrastructure remained in place. Smeets and others persuaded the Curacao government, which had substantial autonomy in tax and business law under the post-war Dutch constitution, to adopt a “ring-fenced” tax regime, allowing businesses registered in the jurisdiction but not actually operating there to pay just 10% of the normal corporate tax rate. This gave such firms an effective tax rate of 2.4% to 3.0% percent, well below the level of taxation in most of the developed world. When the United States and the Netherlands extended the post-war tax treaty covering the European portion of the Kingdom to cover the former colonies now made into formally equal constituent parts of the Kingdom, US firms that created subsidiaries in the Antilles were exempted from the 30% tax on payments to foreign persons or entities that applied to many payments by Americans to foreigners.

Over time, a large market in Eurodollars grew, particularly in London. As deposits in foreign banks, Eurodollar deposits were unregulated by the United States government. As foreign currency deposits, they were exempt from a great deal of local banking regulation in many countries, particularly the United Kingdom. Thus a huge pool of Eurodollars available for investment grew as the United States spent billions on the Marshall Plan and on defense activities in Europe and elsewhere. Countries that feared US sanctions on their financial assets, including the Soviet Union, also sought to keep their dollar assets outside US financial institutions.

When US interest rates rose in the 1960s as a result of the Johnson administration’s increase in federal spending to simultaneously fund the Vietnam War and the “Great Society” social programs, the United States imposed restrictions on using US capital markets to fund international business (Boise and Morriss, 2009). The combination of money free from those restrictions and the lower interest rates available in the Eurodollar market was attractive to US companies

seeking funds. By the 1970s, virtually every major US corporation had a finance subsidiary in the Netherlands Antilles to gain access to the Eurodollar market. As a result, Curacao was the largest Caribbean offshore center.

The Curacao story has an unhappy ending (for Curacao). As the use of Curacao entities grew, US law enforcement agencies began to worry that these entities were being used to conceal ownership of assets. Someone could form a Curacao entity, issue bearer shares as the means of ownership, purchase US real estate, then sell the bearer shares to someone else. Since there was no registry of share ownership, not only did the use of the Curacao entity make the ownership of the US property anonymous but the transfers could be done without reporting and so without alerting US authorities that taxes might be owed. The IRS also became concerned that Americans were using this same device to create entities that they paid money to (creating an expense against their US income) and which was then taxed only at the 2.4% to 3% Curacao rate under the treaty, but returned to the US investor. Again, bearer shares would enable an American to illegally evade taxes using this method. After unsuccessfully attempting to negotiate limits to the treaty's use, the Reagan Administration cancelled the tax treaty with the Antilles in 1984. To prevent this from harming US firms' access to the Eurodollar market, the United States simultaneously ended the need for structures like those provided by the Antilles by restructuring the 30% tax on bond payments to foreigners to eliminate the need for an intermediate entity.

During this same period, other jurisdictions developed their own niches in financial services. In the Western Hemisphere, Bermuda developed as the global center for insurance companies and reinsurance companies; the Cayman Islands created banking and trusts laws that drew business; the Bahamas developed an extensive offshore banking business. In Asia, Hong Kong and Singapore developed roles as financial centers. In Europe, Guernsey, Jersey, the Isle of Man, Luxembourg, Lichtenstein, Gibraltar, Malta, Switzerland, Andorra, and others developed financial sectors. Like Delaware, these are small jurisdictions with few natural resources and small labor forces.

But it was not just these jurisdictions that became providers of law for organizing financial transactions. London and New York became the major centers, offering their own specialized legal regimes. For example, it was the United Kingdom's restraint in regulating Eurodollar transactions—and the belief of financial institutions that such restraint would continue—that made London the center of the Eurodollar market in the 1950s and 1960s. This is remarkable as it occurred even

as Britain heavily regulated and taxed domestic financial transactions, imposing both exchange controls on transactions in sterling, and punishingly high marginal tax rates on individuals' and firms' domestic income. In New York, the bond market grew based in part on New York state law governing bonds, with the crucial feature being a relentless focus on the language of the offering documents and an unwillingness to go beyond it in most circumstances. This history of government restraint in this area gave investors certainty in how they would be treated in the future.

Of course, any country can produce laws that look good on paper; committing to following the laws so that investors have confidence is a critical piece in developing as a financial center. Here the same dynamic is at play as in the comparison of Delaware and California given earlier. If a large country were to renege on the quality of its financial rules, it would suffer damage that would have minimal impact on government revenue. If a small country such as Luxembourg were to do so, the damage would be severe. This “bonding” effect means that smaller jurisdictions can do a better job of credibly committing to maintaining a stable corporate law regime. Further, given the importance of the financial industry to their economies, the legislatures in smaller jurisdictions are much more likely to pay attention to needed changes in the law that are responsive to changes in technology and business organizations. While, as we will see, some corrupt countries become involved in financial services, they do not become major players and often have short lives in that market. More honest regimes attract business over the longer term; Luxembourg is stable and honest (Transparency International, 2013).

Building a jurisdiction on law

In the 1950s, the Cayman Islands were three small, mosquito-ridden, islands with few sources of income—fishing, thatch rope making, and a small amount of tourism (small because of a lack of infrastructure and the mosquitos). The government supplemented meager income by issuing postage stamps for collectors. Today the Cayman Islands are no larger physically (although no longer mosquito-ridden) but their economy is far more robust as a result of financial services (high-end tourism has increased largely due to the financial services business) (Freyer and Morriss 2013). How did these three small islands go from relative poverty in 1960 to pass Britain in GDP per capita by 1980? As with the Netherlands Antilles, a key component was the development of a legal regime that attracted international business.

As Britain shed many of its colonies in the 1950s and 1960s, the Cayman Islands opted to remain affiliated with Britain. Beginning with the 1960 Companies

Law, based on English corporate law, Cayman made a concerted effort to enter the competition for international financial business. Over the 1960s, it added additional statutes creating or clarifying just how various business entities (banks) and relationships (trusts) could be established. Cayman used its lack of direct taxation (although Cayman had plenty of indirect taxes) to attract business, since this allowed entities organized in the Caymans to pay only fixed licensing fees rather than the hefty direct taxes being applied in most developed economies. This made Cayman a neutral location for multinational investment pools, keeping the cost of organizing such efforts low.

When the Bahamas became independent in 1973, investor concern over the post-independence government's efforts at "Bahamianization" of the financial sector workforce led a number of foreign banking investors to shift operations to Cayman. It had modeled its banking statute on the Bahamas' and had licensed banks doing business in the Bahamas in Cayman. Thus, like Delaware's success in persuading companies incorporated in New Jersey to relocate when New Jersey attempted to renege on the regulatory bargain it had made with firms, Cayman was able to capitalize on the Bahamas' misstep.

Beginning in the 1970s, Cayman also began to develop a sophisticated regulatory system that enhanced that jurisdiction's reputation and reduced the cost of doing business there. Although sophisticated financial professionals use Caymanian entities, Cayman opted not to mimic the retail-investor-oriented type of regulation in the United States but instead to focus on preventing risks to the jurisdiction's reputation. It did this by relying heavily on a system built around licensed professionals, whose interests were to preserve the future stream of income possible from their licenses. This encouraged these professionals to report any problematic behavior by businesses to the regulators but allowed the regulators to have a lighter touch and to impose fewer costs on regulated entities than regulators in many other jurisdictions.

Cayman also invested in creating sophisticated statutes and regulations that facilitated particular transactions, such as creating captive insurance companies and investment funds. Caymanian legislators acted much like Delaware's legislators, regularly suspending partisan hostilities to pass legislation needed to enhance the competitiveness of the financial sector and being careful to keep fees at a level that would not—as legislators regularly put it—"kill the goose that laid the golden eggs".

Another key advantage for Cayman has been its continued affiliation with the United Kingdom. Not only has Britain provided considerable technical support

over the years, but Cayman's British affiliation means that its court of final appeal is the Privy Council in Britain. This access to one of the world's highest quality courts gives investors confidence that the rule of law is likely to be respected. Similarly, the regular practice of bringing in visiting judges from the Commonwealth to hear sensitive cases has provided further assurances of judicial independence.

Of course, Cayman's regulatory efforts are far from perfect. The government has made plenty of missteps and the Islands face challenges today. What is remarkable is the degree to which Cayman has avoided wrecking its financial sector while growing to be the fifth largest financial center in the world economy. This success is due to a remarkable record of value-added regulation, in which the Islands have competed for business by enhancing the rule of law and by crafting regulations that promote transactions rather than impede them.

The competitive market for law

The existence of Cayman as a competitor in this market for law has been important for the United States. As Professors Erin O'Hara and Larry Ribstein noted in their seminal book *The Law Market*: "Parties, in effect, can shop for law, just as they do for other goods. Nations and states must take this 'law market' into account when they create new laws" (O'Hara and Ribstein, 2009: 3). Failure to do so, the case in many jurisdictions, means that capital and people are likely to flee to better opportunities, generating greater wealth for residents of jurisdictions that provide better institutions for markets.

Consider captive insurance, a structure by which a business creates its own insurance company to cover its own risks. Why create your own insurance company? Many non-profit hospitals use captive insurers to handle their medical malpractice and other insurance needs. Because a hospital has a better ability than do non-captive insurers to assess the adequacy of its own procedures and staff quality to prevent malpractice from occurring, it is in a better position than a third-party insurer to assess its real risks. In short, a captive owner has an incentive to manage risks to itself that is lacking in market transactions where the cost of accurate disclosure of risks may be higher premiums and the value of safety measures is captured across many firms that participate through the insurance provider. Many industries make use of captive insurance, including trucking and manufacturers with warranties to fund.

Cayman and Bermuda were early leaders in the captive market, but Colorado passed the first US captive statute in 1972 (Morriss and Estes, 2014: 5). Few other

states followed until the market had developed offshore. Nine more states adopted captive statutes by 1992 and more quickly followed as the number of domestic captive insurance companies doubled between 1992 and 2000. The captive market grew, in part, because jurisdictions competing for business innovated regularly. For example, Guernsey created a new form of captive, the protected cell company, which was swiftly copied by US and other offshore jurisdictions. Protected cell companies essentially allow “siloeing” insurance reserves in what might be thought of as different virtual companies within a single entity, increasing the ability to customize strategies for particular risks. Between 1999 and 2005, 15 US jurisdictions implemented protected cell company legislation.

The most successful US jurisdictions, Vermont and Hawaii, have amended their statutes more than 30 times; in Hawaii’s case, there have been an average of 1.36 substantive amendments per year. This suggests an impressive level of legislative attention to a highly specialized body of law, which appears to be a key factor in success in the market. Morriss and Estes (2014) found a 0.491 positive correlation between the number of material amendments per year and the number of captive insurance companies registered. A comparison of the relative success of US jurisdictions suggests that those that reinvest a portion of the revenue from their captive license fees into promoting the jurisdiction have done better than those that do not.

Bad actors (eventually) lose in the competitive law market

The role of law in promoting economic growth in the Caymans contrasts with the sad experience of Antigua’s efforts to establish a financial center without investing in developing the necessary legal infrastructure. Like the Caymans, it had limited economic opportunities beyond tourism, fishing, and agriculture. It too sought to become a center for financial activities. Unfortunately for Antigua, rather than entice a group of Oxbridge law graduates with practical experience in London, the government decided to work with American Allen Stanford and his Stanford International Bank. Stanford invested heavily in local politicians. He became a major donor to the ruling political party, set up a newspaper to promote his allies, and spent heavily on promoting Caribbean activities such as cricket tournaments that bought him influence and goodwill. He was able to capture the Antigua financial regulatory agency, even serving on its board himself at one point—a staggering conflict of interest for the owner of the largest regulated entity. By 2008, the bank claimed \$8 billion in assets, mostly invested in its certificates of deposit.

A private investment analyst, Alex Dalmady found the claims of consistent, high returns suspicious, and in 2009 wrote a widely distributed report suggesting the investments were part of a fraud scheme. Investors could believe his report or not. At the same time, the top Antiguan financial regulator rejected Dalmady's analysis and announced that he believed Stanford's operations were legitimate, saying: "I have never in my eight years here seen a letter from a customer of the bank complaining they had not been paid", and that: "We are not turning a blind eye, but at the same time we cannot allow the blogosphere and press articles to distract us. We have to make sure that when you have a good client that we have never found wanting, we have to stay the course" (Ishmael, 2009).

Later, some of Stanford's employees sued Stanford in the United States for employment discrimination and alleged that he was running a Ponzi scheme. This came to the attention of the US Securities and Exchange Commission (SEC) and the agency launched an investigation that ultimately led to Stanford's indictment on charges of conspiracy, wire and mail fraud, obstruction of the SEC investigation, and conspiracy to launder money based on his activities in the United States. Stanford was ultimately convicted of federal criminal charges and sentenced to 110 years in prison. Antigua was not a credible jurisdiction for financial services. Credulous investors who wanted to believe Stanford's claims of above-market rates of return were taken in.

The key lesson from Antigua's experience is the need for market-assisting legal measures. Allowing a regulated financial entity to dominate a government regulator prevents the development of market-facilitating regulation and instead facilitates fraud.

Basic rules of law, not minute regulation

At the start of this chapter we noted several articles about law that happened to appear in the *Wall Street Journal* on one day. While we have focused on regulatory competition in the financial services and business organization areas, let us return to those examples and contrast the regulatory regimes we are now under compared to what might exist under a stable legal regime not imposing needless complexities.

FDA Nears Rule Shift on Food Ingredients

The first story concerned new FDA regulations for food additives that have been many years in the making. Congress gave the FDA immense powers to regulate food. The result is that industry spends billions a year meeting detailed food

regulations that, besides increasing food costs, tend to push toward uniformity. For those who decry the standardization of our diet, part of it can be explained by the need for producers to follow dense federal rules, whether they make sense or not. A side impact of these rules, as is true with many, is that it becomes ever more difficult for a mom-and-pop start up to enter the food product industry. All producers are subject to the same requirements to prove compliance with detailed regulations. Little firms are at a significant disadvantage. Finally, if a company poisons its customers by putting some bad ingredient in its product, it will be sued in tort. Companies have strong aversion to such litigation and the bad publicity it brings.

EU Official Decries Google Pressure

The next story concerned the EU's complaining that Google "manipulates" search results. If you are old enough, you will recall the same shrieking that went on in Europe, and in the United States, about 20 years ago, due to Microsoft's Internet Explorer's domination of the search-engine market. Just as Google now must spend millions on high-priced lawyers and lobbyists, Microsoft similarly spent huge sums defending itself in a case involving a service it invented and gave away. "Unfair monopoly!" cried the critics. The antitrust suits in the United States, an area of law that is highly uncertain, gradually withered away. Does anyone think Internet Explorer is a monopoly today? Competitors were free to offer alternatives, as they did. Similarly, others can offer services to compete with Google.

Simplistic notions about competition are used to justify attacks on the very firms that drive innovation and higher standards of living. Joseph Schumpeter wrote about the unsettled manner in which competition progresses in a free market. He called it the process of "creative destruction" (Schumpeter, 1942: 83). Innovators enter the market. Many fail but, of those who succeed, existing interests fear the threat. Uber and other software-based firms are roiling the staid, monopolized taxi market.

OSHA Takes Aim at Dollar Tree

In the third example, Dollar Tree stores were required to pay a fine to the Occupational Safety and Health Administration (OSHA) for numerous safety violations. Boxes in the storerooms were piled too high. Some boxes were in front of electrical panels. Why were the boxes piled high? Largely because the holiday inventory had come in; retail sales go way up during the holidays, so the stores need more merchandise. That aside, who is to say that the rule saying boxes cannot be piled more than the federally mandated inches high is the optimal height? Even

if a little lower, boxes could still fall. If piled three inches higher, the added risk is miniscule. Even OSHA noted there had been no injuries, but you cannot be too careful! Yes you can. Safety is costly. Companies are supposed to comply with dense OSHA regulations that control nearly every aspect of physical operations. Are the rules beneficial? The stores owners know that if they endanger their customers or employees, lawyers will be happy to represent them in litigation for the damage caused by negligent acts. No retailer wants such problems. OSHA's inability to compare the costs and benefits of its regulatory efforts prevent the agency from such considerations and, on the margin, are likely to expand the regulatory regime past the point at which the regulations add value.

Board Backs Access to a Pricey Drug

The next story concerned a costly drug being approved for use in treating cystic fibrosis under Medicaid in Arkansas. The poor are provided access to certain medical benefits under Medicaid. Drug companies are required to sell their products at significant discounts under such government coverage. When drug companies sell their products in different markets at different prices, there are complaints about price discrimination, but that is exactly what federal law requires when selling to recipients of certain government benefits. The drug companies face what Schuck calls uncertain law, as state and federal rules can be in conflict.

Disabled-Access Lawsuits Surge

Fifth among the stories was one concerning the rise of disability access suits to places of public accommodation such as restaurants. Small hot dog parlors must retrofit to meet federal standards for wheelchair and other disability access. The one mentioned in Miami had 30 violations. No one would disagree with the idea of granting respect to persons with disabilities but, if every business must comply with costly regulations, small businesses tend to be at a disadvantage relative to the cookie-cutter corporate chains that have standard designs that comply with all regulations. Quaint little hot dog shops will go by the wayside. In many instances, no disabled person has complained; rather "testers" go looking for violations of uncertain and dense federal rules and then bring suit.

Accessibility Claims Expected over Websites

Similarly, the sixth story concerned federal standards for website access by the disabled. Websites must provide alternative text, audio, and other alternatives for various

disabled users. H&R Block was picked on to make an example. No doubt this large company can afford to hire web designers to add the needed features but that will not be the case with many smaller web designers or small firms with sites. Forcing all web-based vendors to meet costly design standards will limit innovation and competition.

Trial Turns to “Secrecy” at UBS

The next article concerned the SEC’s prosecution of a Swiss banker for following Swiss law but not following US law when dealing with American clients. The jury would not convict. This relates to the discussion of financial services in this chapter. Companies operating in the Cayman Islands and other such jurisdictions are often branded by politicians and US regulators as bad actors akin to Allen Stanford in Antigua. Some in the United States government would love to force all jurisdictions to adopt rules identical to those adopted in the United States so that it could have a monopoly over legal rules. The rules in Switzerland and other financial centers are technical but, unlike the uncertain regulatory regime in the United States, the financial centers focus on rules needed to protect the interests of multiple parties in highly complex transactions. The financial centers know investors will flee if they exhibit legal uncertainty.

Mortgage Rules Move Closer to Final Form

Finally, the last story concerned the nearly complete new mortgage-industry rules soon to be adopted in the United States. The regulators claim that these rules will prevent a repeat of the 2008 financial meltdown in the United States that largely originated in the mortgage industry. What is not discussed is that the mortgage mess did not occur in Canada or the European Union; it was an American special. The subprime meltdown has multiple causes but among them are what Schuck would call differentiated and uncertain regulatory requirements to expand the pool of people eligible for mortgages to include those lacking proper credit in pursuit of political points for expanding home ownership, lax regulation by the regulatory agencies charged with banking oversight, and an extended period of artificially low interest rates caused by central bankers actions (Taylor, 2009; Norberg, 2009).

Using the law to build, not destroy, economic growth

These examples illustrate an important distinction among the types of law, a distinction that is too often neglected in today’s debates over regulation. Law and legal institutions can serve two quite different functions. First, law can provide a means of reducing the cost of engaging in wealth-creation. Trade, creation of

business entities, facilitation of investment—all of these are cheaper and easier to do within a well-developed framework of laws. By providing “off the rack” default solutions, which may well be complex, the legal system can cut transactions costs. Contract law is a good example of this. By providing regulatory regimes that make transactions more trustworthy, the legal system can encourage wealth-enhancing transactions. The development of corporate governance law in Delaware and captive insurance law in various jurisdictions are examples of this. These laws avoid the problems of regulatory capture because they are framed as generally applicable laws, which economic actors can opt out of by either writing their own contract provisions to substitute for the defaults or opting to use a different jurisdiction for a transaction.

Unfortunately, law can also impose costs greater than the benefits they produce. Even well-meaning efforts to address market and social ills tend to fall into this category because of the public choice issues. Those with the most to gain from involvement with the legislature and regulators are most likely to influence the regulatory process. Growing complexity, in the forms discussed by Schuck (1992), increases the likelihood of bad outcomes because it both raises the costs imposed and makes concealing special interest easier.

Improving the performance of our economies requires more attention to promoting wealth-increasing legal developments while restraining those that destroy wealth. One means of doing so is by enhancing competition among jurisdictions. As we saw in the examples above, these are powerful forces that can promote value-added legal institutions. That the Cayman Islands developed from a quiet backwater into a modern financial center, Vermont developed a captive insurance industry, the Netherlands Antilles found a (temporary) opportunity in facilitating US corporate finance, and Delaware has become the market leader in corporate law are examples of the power of competition to transform even small jurisdictions into powerhouses. To gain the benefits of such competition, care must be taken to avoid the fate of Antigua. Avoiding regulatory capture by fraudsters requires understanding and investment in sound institutions.

Foreign Account Tax Compliance Act

As we have focused on financial regulation, we close by considering the Foreign Account Tax Compliance Act (FATCA), passed by the US Congress in 2010 as part of its post-financial-crisis efforts at economic stimulus. Copycat statutes followed elsewhere, including “son of FATCA” in the United Kingdom and “mini-FATCA”

in France. These statutes impose complex costly requirements for information exchange between financial institutions and governments. The Banking Federation and Institute of International Bankers estimate that the top 30 non-US banks will spend \$7.5 billion on compliance with FATCA alone. These compliance costs add nothing to the global stock of wealth—they are simply additional costs of doing business internationally. On the margin (and for some distance from the margin, if the \$7.5 billion estimate is correct), the FATCA requirements will reduce the volume of international financial dealings. That will in turn reduce economic growth by reducing trade.

Let us propose an alternative way to view the role of law. There are many countries where a meaningful rule of law is absent or inadequate. Jurisdictions that provide sophisticated legal environments for structuring business transactions are, in effect, exporting the rule of law to those countries that lack it. For example, considerable investment into China flows through Hong Kong's financial sector and the British Virgin Islands. They offer tested legal entities and structures for conducting international business. Similarly, a study of the role of the island of Jersey in the UK economy found that investment through Jersey produced £2.3 billion in annual tax revenues and supported 180,000 British jobs (Capital Economics, 2013).

Why are these jurisdictions used? Hong Kong and Jersey have excellent courts; the British Virgin Islands has a well-developed legal regime for the governance of offshore corporations (IBCs). These advantages give investors confidence that their legal advisers' predictions of how possible disputes will be handled are accurate. They also provide assurance that unanticipated disputes will be handled fairly. As noted earlier, these advantages come in part from the use of smaller jurisdictions that are both specialists and can be relied upon.

In contrast to legal structures that add value, laws such as FATCA and its progeny add needless or low-value complexity and reduce growth. These laws create barriers to investment. They divert resources from the budgets of developing countries into administrative efforts that create costly compliance mechanisms with minimal benefit. Creating a regulatory framework under the guise of consumer or investor protection that is intended to deter the free movement of funds harms the rich and the poor

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