Should all voluntary exchanges be legal?

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1. *General Framework*

Should we allow two consenting adults to enter into any agreement that they want? For example, could this involve prostitution, selling organs (e.g., kidney), voluntary slavery, or in the extreme case, giving up one's life in exchange for money (e.g., organ harvesting, such as providing a live heart for transplant)?[i]

Whether some trade or transaction can be allowed is a basic question of resource allocation and the standard logic of economics evaluates resource allocation on three criteria: efficiency, equity or fairness, and liberty.

Efficiency is the sense in which resources should flow to their most productive use and goods should flow to those who value them the most. The logic is, whatever is the status quo, some who can make more out of an asset or value a good more than the owner, will be able to make an offer that would be mutually agreeable. There are two main qualifications of this criterion – first, those who are poor may value something or make better use of a resource but cannot express their valuation through money, and second, a transaction between two parties may negatively affect a third party, and so efficiency has to be calculated by taking into account these external effects.

Equity or fairness or just treatment can mean many things, depending on one's moral values, which are subjective. Still, a common element is symmetric treatment of people in similar situations, independent of their identity. This could be symmetry across individuals who are actually placed in similar situations – if there is a shortage of a good, it is either divided equally, served on a first-come-first served basis or allocated by lottery. Even though in the last two cases not everyone gets the same outcome, they faced the same process or the same odds. It could also be symmetry across potential situations – treating others like the way we would like to be treated if the roles were reversed. The main qualifications to the equity argument are, there may be some dimensions in which equity is hard to tackle (for example, talent or capacity to be happy), and that equity does not mean equality of outcome, but fairness of the underlying process.[ii]

Liberty involves the notion of autonomy or the freedom to make decisions for ourselves. This notion takes property rights very seriously, including over oneself (body, life) and opposes any restrictions on voluntary exchange respecting these property rights among consenting adults. The main qualifications to this criterion is the liberty of different individuals are interrelated, and one can only be free to do something that does not interfere with the liberty of others. Like with efficiency, external effects pose the most significant challenge to the criterion of liberty.

A few clarifying remarks are in order. We are going to approach a consequentialist point of view – markets should be evaluated in terms of the consequence of the resultant resource allocation on individuals. This does not necessarily have to be their utility or welfare, but some other objective indicator, such as income, poverty, health or life expectancy. This is to be distinguished from a rights-based approach which would support markets or other institutions for their ability to promote some basic rights (e.g., freedom of association) and not their consequences.[iii] Also, we have to keep in mind we cannot evaluate the case for restricting some markets or trades without specifying what an alternative allocation is. For example, banning kidney sales means either coming up with some system based on donation, or exchange, or preventing any form of kidney transfer. Each method will have different welfare consequences for different groups of people.

The case for voluntary trade is best-expressed by Milton Friedman: "..both parties to an economic transaction benefit from it, provided the transaction is bi-laterally voluntary and informed" (Friedman, Chapter 1, Capitalism and Freedom, University of Chicago Press, 1962). We should point out right away that in many situations, the assumptions that parties are informed does not hold. This could be due to informational imperfections (e.g., people could be cheated or induced to sell or buy something under false premises) or due to cognitive limitations. For example, children or those with mental illness are obvious cases where the concept of voluntary trade or contracting does not apply. But all of us are some distance away from the perfect information and foresight assumption that rational choice often assumes, where we are supposed to know the full consequences of our actions on our future selves. These issues are substantive enough to merit a separate treatment. In this essay we will assume information is symmetric and perfect and all decision makers are fully rational.

2. *An Example*

Let us consider an example where three individuals are shipwrecked and arrive in an uninhabited island.

Let us assume two things are valuable for survival in this island: security (from wild beasts and attacks by inhabitants from neighbouring islands) and food. Each individual is able to carry out both tasks, but they differ in their comparative advantage. In particular, one of these individuals is braver than the other two and is good at providing security from these threats. We will call him A. The other two individuals are good at gathering and cooking food. Let us assume they are identical and call them B and C.

Each person can live in some part of the island that is far away from the others and can survive on his own but there is a loss involved from not taking advantage of division of labour. A will not have to worry about security but will struggle to gather food, and vice versa for B and C. Let us assume these factors cancel out and so the autarchic payoffs are the same, namely, on their own each individual achieves a welfare level U.

The most cooperative arrangement the three of them can have is one where A provides security for all, while B and C work up to their ability to gather food for all of three of them. Let us assume they all value food equally and so agree on one-third each in a cooperative arrangement. Let us assume all three of them get a utility of W>U under this arrangement. Of course there could be some unequal division too: for example, A could say I need more than one-third, since the skill I have is relatively scarce. In fact, taking this argument to the limit, the maximal share that A can achieve is one that just about provides B and C with a minimum payoff so that they do not feel they are better off not dealing with A (and live on their own, or come up with some agreement among the two of them).

How can they sustain such an agreement? Suppose, however implausible it sounds, that there is a perfect legal system available in this island. Let us invent the fiction of a magical black box to make things concrete. Suppose everyone has access to a button on a remote and the moment it is pressed, the machine is activated and is able to verify the true situation and enforce the agreement using a sharp jolt of pain via an invisible ray to whoever is proved to be guilty, whether the accused or the accuser (in case someone makes a false accusation). The punishment, while not lethal, is potent enough so that everybody would try hard to avoid being hit by it and therefore, anticipating it, people will stick to the agreement.

Above we have talked only about the role of the legal system to enforce the agreement among the inhabitants regarding division of tasks and goods. It can be extended to the protection of life, limb, and property. Suppose they all agree that whatever personal items they have (carried from the ship or stored food) cannot be stolen and similarly, no one can inflict any bodily pain on anybody. We can think of the black box's magic powers being able to block any threat to an individual's life, limb, or property in addition to enforcing agreements in an identical way: for example, anyone facing a threat can press a button on the remote and the machine can judge and enforce appropriate punishment instantaneously. This would deter people from trying to steal, rob or beat up one another and also, deter false accusations.

These individuals are also able to come up with further bilateral or collective agreements that may make them better off. For example, assume each individual can be ill in a given day with some probability and then he can request one of the others to do his task for that day and promise to reciprocate when the need arises. This is like a mutual insurance agreement. Once again, if they agree to do it, they can use the powers of the black box to enforce the agreement, in case any individual might be tempted to renege.

Let us consider an alternative scenario, where the black box can protect individuals from each other as far as threats of theft, robbery, or violence is concerned, but is unable to enforce any agreements, bilateral or collective. The individuals may still be able to achieve cooperation by using informal methods of contract enforcement: for example, if one party does not keep his side of the bargain, the other party (or both the other individuals) can refuse to cooperate with him in the future. So long individuals gain substantially from cooperation relative to autarchy (W is high enough relative to U) and put some minimal weight on future consequences of their actions (that is, they are not too short-sighted), they can achieve the same degree of cooperation that was possible under perfect contracting. If these conditions do not hold, then the individuals will have to live with autarchy, or achieve a lower degree of cooperation. For example, rather than each completely specializing in the task they are good at, they may partly specialize (e.g., A spends some time on gathering food and B and C spend some time on ensuring their own security), which results in some loss of efficiency.

Essentially the legal system facilitates cooperation by punishing non-cooperative (or hostile) behaviour. Without the legal system in place, the most an individual do is to refuse to deal with another person who has behaved in a non-cooperative way. But the problem is more serious. If the legal system cannot protect individuals from threats of theft, robbery or violence, then the autarchy payoff U described above may not be attainable. That assume people are not cooperating but they are subject to legal protection from violence or theft or robbery. For example, no longer subject to the fear of punishment by the black box, A can threaten to beat up B and/or C, and get a larger share of food than would be possible if either formal or informal system of contract enforcements were in place. Here too there are limits: too much coercion can lead to someone dying (in which event he cannot be exploited any more), retaliating, or running away from the island. Still, without a legal system protecting a person from threats of violence or loss of property, their autarchic payoff would be less than U, say $V<U$. We can define this as a state of anarchy.

Let us now go back to the magical black box but introduce the following element which makes the legal system less of a deus ex machina, and more of an institution that in the end, needs humans to run - whether it is the police force, the judges, lawyers, witnesses, or members of the jury. Assume that the black box can no longer enforce contracts or protect individuals from threats whenever *one* person complains. For every complaint, there has to be a third person who needs to cooperate to activate the magic powers of the machine. For example, if A is trying to take away all of B's food, then B needs C's cooperation to activate the black box (both of them needs to press a button) and after that, the story is like before. The catch is, without a third party (we can think of this person as a witness) the box cannot be activated.

I wish to argue that in this set up, having no restriction on freedom of contracting can lead to unravelling of the rule of law.

Suppose A tells B that I will give you some extra food than your agree upon share of one-third. In particular, I will not hurt you or steal anything from you, or renege on my promise to give you extra food. If I do, you can file a complaint and get legal recourse through the black box, assuming C's cooperation. In exchange you have to promise not to act as witness against me, if C complains about me. This way, A can extract extra food from C, and give some of that to B, while ensuring that B will not help C get redress from the legal system. This way, B is better off agreeing to this deal. He is worried that A might not keep his word and similarly, A is worried that B may not keep his word. However, if A and B have a dispute, C can always be the witness. Under our assumption, this will establish the truth and the person deviating from the agreement will be punished.

If B values the extra food sufficiently, he will agree to this. He will realize he is giving up a freedom to act as a facilitator of the legal process, but is happy to receive the extra food from

A, which in turn is extracted from C. B is, however, not internalizing the fact that now A can extract more food from C and in the event of that dispute, he has agreed not to be a witness.

This will cause C to realize that as far as he is concerned there is no rule of law and will leave the agreement. But if that happens, B will lose his legal protection too – there will be an unravelling of the rule of law in this island. Each person will end up with U each and so all of them will be strictly worse off. The above, however, is a welfarist criticism that views freedom of contract as an instrument.

Actually, the likely outcome is worse than this. Since now the legal system is not functional, threat of violence or expropriation will go unpunished. Therefore, the actual payoff of some of the individuals will be less than U. For example, assuming A has a comparative advantage in physical strength, he can intimidate B and C by threat of violence and expropriate some of their autarchic output. In other words, we have provided an example, that unrestricted freedom of voluntary contracting may not be desirable, even if the objective is to maximize freedom of voluntary contracting and freedom from expropriation and violence. There is an externality – when someone gives up his rights, he is not realizing or not putting sufficient weight on the fact that he may be affecting others' rights negatively. Therefore, he does not completely "own" himself, as he is a stakeholder of the legal system. Therefore, society can put restrictions on his individual rights. The problem with the libertarian's approach is they treat the legal system as a *deus ex machina*.

In this world, making the right to appear as a witness not saleable would make everyone better off not just in terms of welfare from the resulting resource allocation, but also if they intrinsically value having the option to exercise the freedom of voluntary contracting. However, how to enforce this law is tricky in a scenario with just three people. For example, A and B could have an informal agreement that B would never act as a witness against C. We would have to assume that this is not legally possible – and accordingly, for the black box to work, we have to make sure that breaking this law is punished. Anticipating the possible unravelling of the legal system, the three individuals would agree to make any agreement that involves giving up the right to act as a witness illegal. In other words, the box will have to programmed such that if C complains about A, and B refuses to act as witness, he will receive a punishment. Anticipating this, B will agree to act as witness (if C is making a false complaint, he will get punished) and given this, A will not be able to break the law (if he does, he will get punished). The rule of law will work again.

3. *Discussion*

I must acknowledge that the example presented above is rather special. It works due to the small number assumption: every potential slave is a potential witness without a substitute. If we introduce another person in this island, say D, then B signing away his right to cooperate with C, if C were to file a complaint against A would not matter too much as D can be called upon to do the job. Of course, A can try to cut a similar deal with D like he has with B but there are limits of how much he can offer each person by taking unfair advantage of C. Also, D can be inherently honest and refuse to be party to such an agreement. Therefore, slavery of a small section of the population is certainly consistent with the rule of law in theory. But in practice there are several reasons to worry. I will discuss a few: namely, coercion, externalities, and unequal exchange.

First, A can always use the threat of coercion to subjugate others. For example, he can threaten D with violence not to cooperate with C were he to choose to complain against A. Assuming preventing this kind of coercive behaviour is not unilaterally prevented by the magic black box, but needs the cooperation of others, we do have an equilibrium where A intimidates everybody by fear. None of B, C or D dares to cooperate with one another to help activate the black box to punish A, if A threatens all of them simultaneously. There are many examples (see Kaushik Basu's One Kind of Power, Oxford Economic Papers, 1986) where a bad coercive equilibrium is supported by fear of retaliation. For example, if I fear others will not cooperate with me if I turn against A then I too will not cooperate with anyone who turns against A, making this self-fulfilling. If all those who are intimidated could coordinate then they could move to another equilibrium where each expects others to cooperate and knowing this A will not dare to exploit or expropriate anybody. Therefore, any discussion of voluntary trade, whether formal or informal (i.e., not based on explicit contracting) has to be based on a premise of law and order that protects life, limb, and property.

Second, certain extreme forms of contracts, for example, voluntary slavery or legal prostitution, may make it difficult to prosecute involuntary slavery or human trafficking. In our example, B agreeing to do whatever A asks him to do voluntarily makes it difficult to prosecute A if he coerces C to do whatever he asks him to do. For example, those forced into the flesh trade will find it difficult to return to respectable society and have consequently little incentive to testify for fear of losing even the livelihood they have. Another example is as follows: various African countries have petitioned from time to time that they be allowed to sell their stockpile of seized elephant tusks. The economic argument in its favour is very strong - it should drive down the price of illegal ivory and make poaching less profitable. The flip side, is that if you make ivory conditionally legal, who is going to track what came from which source? If you make the whole thing illegal, the police will find it much easier to go after the offenders. Making kidney sales legal in a country like India can be defended on the grounds that given how imperfect our law enforcement system is, it could lead to far more abuses than if it is kept illegal, fully recognizing that some of this will continue to happen illegally, and also, that those who need kidneys will be under-served in this regime.

It has to be acknowledged that our argument against making certain trades legal based on externalities is subject to the critique that everything is subject to some externality or the other. Leaving aside abuse and having the potential of extreme outcomes, there is also the case of significant externalities. Take the case of hard drugs. To the extent people are influenced by peers, legalizing drugs may lead to a drug-use epidemic, which indeed will have consequential welfare impacts. But here too one has to be careful – once we start having preferences over other people's preferences, one can start making many things illegal. Here the clinching argument has to be significant health costs. Take on the other hand, Basu's example of labour safety standards. It suggests that if you make offering these standards voluntary, then those who value them more (e.g., because they are risk averse) will be made worse off by those who don't (less risk averse). The latter will be willing to accept a higher wage, and the demand for the former will fall, causing their wage to fall. There are several problems with this argument. You could argue that the regulation itself was unfair to start with, which made risk-neutral workers worse off and so it is not clear why we should take the regulation-benchmark as the morally relevant one. Also, another problem with this argument is externalities are pervasive and by this logic, we have to make arbitrary interferences with the operation of market forces. For example, suppose we feel art films should be promoted and for that, we agree to subsidize their ticket by taxing commercial films. This would cause the supply of art films to be higher and that of commercial films to be lower by standard arguments. If the subsidy is removed, the supply of art films will fall and that of commercial films will rise, and art-film lovers will suffer some loss while commercial-film buffs will gain. Is there really a good reason to subsidize the art film to start with?

My sense is most people will support regulation if the trades are truly consequential in terms of human welfare (e.g., involuntary slavery or human trafficking), subject to abuse or significant externalities. Using the notion of primary goods of Rawls or Sen's capability theory, we can all agree without knowing our precise preferences over all goods and services, about what are the things that really matter. Life and liberty are important enough and so trades that may have unintended or perverse impacts on these are the ones that make us morally uncomfortable. Selling one's hair is OK, but selling kidneys is a bit problematic because it could put the seller's life at risk (especially in poor countries with bad institutions and infrastructure). Suppose there is no health risk as such – still there would be a case for tough regulation, since the legality of trade can encourage procuring kidneys through coercion and that may threaten their lives. Carrying that logic, allowing legal organ harvesting is deeply problematic even if some people agree to do it voluntarily because that may de facto encourage murders, and given this potential for abuse, the impact on an unwilling person would be morally catastrophic. Another way to state the criterion is, if others doing something to us make us upset enough, we should agree to a law that prevents everyone from doing it. Therefore, playing loud music at odd hours is a valid externality, but a child crying in the middle of the night is not.

Finally, we turn to the issue of unequal exchange. A lot of standard arguments for extreme trades are driven by the unequal nature of that exchange – someone is desperately in need of money and that is why is doing something extreme (e.g., selling off his child). Here though the argument cannot be ban any trade that is distress driven (ban land sales?). Rather the argument is to directly intervene and make sure people have access to some social safety net when they are subject to some negative shock. Here poverty is the problem, not trade-possibilities. To ban those trades, some other argument has to be used – for example, selling children does not respect their basic liberty and is akin to involuntary slavery.

4. *Reflections on the Libertarian Freedom of Voluntary Contracting Argument*

Libertarians have two important points. First, if you truly own something you should be free to sell it or use it in any way you want, without harming others. Second, even if we find transactions between two parties not to our taste, unless it directly impacts us, we should not let “preferences over other people’s preferences” guide policy. We have examined limits of these arguments, by highlighting the role of externalities, coercion, potential for abuse and extremity of outcomes. In particular, there is a paradox in the heart of libertarianism. They want to maximize individual freedom, and this includes entering into voluntary agreements with each other, whatever they might be. Without any direct effect on third parties, libertarians would not support any restrictions on these. Yet, to enforce such contracts one would need a strong legal system and they take it as a black box or a deus ex machina which is unaffected by the contracts people enter with each other. We have argued how the integrity of this system does assume certain freedoms are not free to be given up and certain voluntary contracts (e.g., slavery) should not be allowed. Otherwise, these agreements and freedoms may lead to the breakdown of the legal system. In a world where there is significant initial wealth inequality, allowing voluntary slavery will allow them to eventually undermine the legal system since all the potential witnesses have been bought out as slaves by them. A similar argument works with allowing sale of votes: if that is legalized, one cannot have democracy since those with more money will buy the most votes and enact any legislation they want. A lot of arguments against inequality touches on this but the problem is not with inequality per se – the problem is the integrity of the legal system in which all exchanges are embedded.

To sum up, liberty is not free – to ensure liberty we need the power of government to protect people from external threats and from each other, namely provision of law and order. This is a tension at the heart of libertarianism – voluntary trade and contracting can only be supported if there is a strong underlying coercive deus ex machina, in the form of a legal system. But such an institution is not likely to stay within its limits, and could exercise its power in undesirable ways.

In this respect there is a similarity between libertarians and those who support central planning. If we assume a *deus ex machina* then central planning promotes a fairer and more efficient allocation (by taking care of externalities) than markets. A planner who has all the information, and can implement any allocation it wants, can implement any objective better than other institutions such as the market. Indeed, if this objective is the same as social welfare, however defined, then no one can do better than the planner. But the trouble is, if any individual or group is given such powers, what is the guarantee that it will maximize social welfare and not its own welfare?

There is no black box, either a perfect law enforcement system or a central planner. Both systems are utopian because sufficient thought is not paid on the incentives of the law enforcers or the planner. With great power comes great incentive to abuse it, and so naturally the question becomes who will monitor the monitor. At a logical level this might seem like the problem of infinite regress – if there someone who can do it, who will monitor this person, and so on. However, in reality society uses methods to tackle this all the time – through democratic accountability and checks and balances. We all monitor each other - voters monitor politicians, politicians monitor bureaucrats, judges monitor bureaucrats and politicians, and so on. This system is inherently messy – it does not have the logical neatness of either a free market or a central planning system. But it has the advantage of facing explicitly the problem that is at the heart of the other two systems: to get a desired outcome, some degree of coercion is needed in the background. But the ability to coerce is the source of power, and power is something that is inherently subject to abuse. To check, this power has to be decentralized, and there has to be mutual checks and balances. Economic problems cannot be studied in isolation from the political problem of limiting the power of the state or elite groups in society, whether feudal lords, or crony capitalists.

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[i] We can rule out right away the legal right to enter into contracts that involves carrying out illegal activities since that boils down to making it legal to break the law, an obvious logical contradiction. This makes legalizing bribery or criminals writing contracts with each other concerning carrying out crimes unenforceable.

[ii] See Ghatak, "Not All Inequalities are Equal" Anushtup, 2014.

[iii] See Amartya Sen's "The Moral Standing of the Market", Social Philosophy and Policy, Spring 1985 for a discussion of these alternative approaches.