The Sickest Patients Need the Most Medicine: A Response to Margalioth and Webber on Law and Macroeconomics: Legal Remedies to Recessions

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Yoram Margalioth and David Webber offer fascinating, yet very different, takes on Law and Macroeconomics: Legal Remedies to Recessions.1 Instead of responding to their insightful comments seriatim, I will highlight a common theme that I believe underlies both of their respective comments.

My book argues for expansionary legal policy—law and regulation should seek to stimulate spending in the economy when there is excess unemployment. Webber acknowledges the analytical case for expansionary legal policy, but express concern about the practicalities. As Webber asks:

How should legal actors know when to begin applying macroeconomic considerations and how will they know what to do? Should the Federal Reserve file legal briefs asking for just such consideration and suggesting courses of action? How else will judges know what the right course of action is, even if they are willing and able to consider macroeconomic effects?2

Treating sick macroeconomies and treating sick patients

I acknowledge the concerns, and thank Webber for expressing them cogently but fairly. Indeed, if these concerns were expressed about a typical law and economics

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2 Webber, Id., at 15.
policy recommendation, I would consider them devastating. Applied to law macroeconomics, however, I think they overstate the difficulty of making effective expansionary legal policy. Margalioth’s essay is a cogent example of why. To use an analogy, I consider law and macroeconomics to be law and economics for sick economies, while law and microeconomics is law and economics for healthy economies. Just as it is easier for a doctor (or even a bystander) to help a very sick patient than a well one, so too is it easier for judges and regulators to use law for good when the economy is sick than when it is well. As Margalioth’s essay demonstrates, the Israeli macroeconomy was sick during the 1980s. Law and macroeconomic interventions therefore worked well, in spite of Webber’s legitimate concerns.

Profound macroeconomic problems, like very ill patients, are relatively easy to spot. Truly deep recessions can be identified by historically high unemployment numbers, historically low interest rates, and extraordinary central bank economic interventions. Hyperinflation, defined as monthly inflation over 50 per cent, is noticed by and affects everyone in the economy. Microeconomic failures, by contrast, are harder to diagnose and more contentious. Just as many patients suffer from chronic conditions that are unlikely to cause grievous harm in the short run, so too do most economies experience numerous microeconomic failures. Patents, for example, create deadweight loss, as the patent owner charges monopoly prices for access to the patent owner’s intellectual property. The prospects of patents, however, may be necessary to encourage innovation. Determining the appropriate balance between innovation incentives and deadweight loss requires considerable expertise, and may vary across time, place, and industry.

Perhaps more controversially, I consider profound macroeconomic problems relatively easy to solve—as a conceptual matter. The vast majority of economists agree that mass unemployment could be reduced if people spent more. Similarly, hyperinflation ends when the public stops expecting runaway price increases caused by a rapidly expanding money supply. Recessions (and hyperinflations) are “coordination failures”, not technological failures. In a previous article, I made the related argument that law and macroeconomics is law and economics for recessions while conventional law and economics applies during other periods. See Yair Listokin, Law and Macroeconomics: The Law and Economics of Recessions, 34 Yale J. On Reg. 791 (2017).

In a poll of prominent economists in 2009 by the University of Chicago Booth School of Business, for example, over 90% (on a confidence weighted basis agreed with the statement that “Because of the [Obama Stimulus Package], the U.S. unemployment rate was lower at the end of 2010 than it would have been without the stimulus bill increasing government spending would reduce unemployment.” See http://www.igmchicago.org/surveys/economic-stimulus (last accessed August 7, 2019).

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how to end them in theory, but have lacked the institutional capacity to end them in practice. And law is a paradigmatic tool for preventing coordination failures.9

Here too, the analogy of economy to a patient is helpful. If a patient is bleeding profusely or suffers a heart attack, then we do not need a hematologist or a cardiologist to intervene. Any bystander who can stop the bleeding with a makeshift tourniquet or shock the heart with an automated external defibrillator (AED) can help. Similarly, we do not require an expert to help a very sick economy. Any regulator or judge who can increase spending can help when there is mass unemployment. The level of expertise that would be required to intervene in determining optimal patent protection levels is not necessary when dealing with deep recessions.

Effective expansionary legal policy requires regulators and judges to have a sense of what will increase spending. This is not a trivial question, and there are undoubtedly many cases in which the effects of a given ruling or decision have ambiguous effects on spending. But there are also many cases in which the effects of a ruling or regulation on spending are relatively clear. When the U.S. Department of Justice refused to give the Keystone pipeline a permit, the decision almost certainly reduced investment spending. (Keystone’s developer did not immediately start building an alternative pipeline.) In an economy with excess unemployment, the decision was a macroeconomic disaster—and expertise is not necessary to evaluate the macroeconomic aspects of the decision.10

James Tobin, Nobel Laureate in Economics and a giant of macroeconomics, put the issue well when he said “it takes a lot of deadweight loss triangles to make up for one output gap.” What he meant was that the typical question of microeconomics (and thus law and economics)—how to make a market marginally more efficient—entails much lower stakes than the typical question of macroeconomics—how to mitigate clearly inefficient deficiencies in production. As a result, we should not be afraid if, as Webber warns, “plenty of legal actors will have to consider the macroeconomic effects of their actions without much training.” Just as we want bystanders to worry about the health of their very ill neighbors, even if they are not trained in medicine, so too do we want legal actors worried about macroeconomics during times of mass unemployment or hyperinflation.

9 See, e.g., Scott Shapiro, Legality (2013).
10 Balancing macroeconomic considerations with other concerns is undoubtedly difficult. Keystone implicated intense environmental concerns as well as macroeconomic ones. But expertise in macroeconomics will not resolve this problem. Even if there were a judge that were an expert in every relevant consideration, the judge would still need to know how to balance possibly incommensurable values.
Implementing law and macroeconomics

Margalioth’s illuminating essay offers an exemplary example of this principle. In 1985, with inflation exceeding 400 per cent on an annualized basis, it would have been daft for Israeli lawmakers, regulators, and judges to focus on business as usual. Many of them may not have experts in macroeconomics, but their input was essential for ending the near-hyperinflation. Indeed, some of the 1985 rescue plan’s legal innovations, such as the “Hahesderim Law,” proved essential to the labor market and money supply interventions that helped alleviate the crisis.11

I think the approach adopted by Israel in the 1980s should be followed whenever there is a macroeconomic crisis. Law should not only respond to macroeconomic crises in practice. It should do so explicitly, making for more robust and transparent precedent. Thus, I agree with the outcome but disagree with the Delaware Chancery Court’s use of stealth macroeconomic reasoning in In re the Bear Stearns Companies, Inc. Shareholder Litigation.12 This case concerned JP Morgan’s agreement to acquire, with tens of billions of dollars of support from the Federal Reserve, the failing investment bank Bear Stearns Companies, Inc.13 The Fed’s support for Bear Stearns reflected its judgment that Bear Stearns’ failure might cause a financial panic. Upset about the $2 per share merger price from JP Morgan, Bear Stearns shareholders sued the company in a Delaware court, arguing (with good reason) that some of the provisions of the merger agreement between JP Morgan and Bear Stearns violated Delaware law. As Webber explains, Delaware, or any other court, could not functionally reject the bailout/takeover of Bear Stearns by JP Morgan for macroeconomic reasons—a rejection might have triggered a financial panic. The terms of the deal, however, likely violated Delaware law on shareholder coercion.14 In response, a Delaware Court engaged in the “strategic use of comity” to implicitly reject the shareholder litigation concerning the Bear Stearns bailout mergers and acquisitions deal, thereby avoiding the creation of bad precedent about shareholder coercion in merger litigation as a general matter.

I think the Delaware Court’s approach in Bear Stearns was flawed for several reasons. First, the strategic use of comity decision tarnished Delaware procedural law. If Delaware would usually decide on the merits of shareholder lawsuits, then the Bear Stearns decision suggested otherwise, leaving future plaintiffs and defendants with uncertainty. Second, punting on the decision

11 Cite to Margalioth, supra note 1.
14 Kahan and Rock, supra note 13, at 721–23.
just forced another jurisdiction, in this case New York, to make the hard decision. If New York mergers and acquisition law has been muddled as a result of the decision, then the Delaware decision represents free riding rather than an improvement. Third, and most importantly, the Delaware court missed an opportunity to make important new precedent. As I have argued elsewhere (with Inho Mun), mergers and acquisitions law (and corporate law in general) should be different in financial crises because the company’s shareholders are no longer the residual claimants of the firm. As a result, the Delaware Court should have improved precedent with explicitly macroeconomically contingent common law. In financial crises, Delaware law would be different from ordinary circumstances. If Delaware corporate law is in fact different for financial corporations in financial crises than in ordinary times, then Delaware law should say as much rather than pretending to pursue business as usual.

Business cycle varying-law may seems arbitrary to some, as Webber alludes to. But I would argue that context-sensitive law is the norm rather than the exception. Decisions regularly adjust in response to important contextual factors. And I would argue that the state of the business cycle is an incredibly important contextual factor. Law should explicitly acknowledge this obvious fact to make precedent clearer rather than engaging in procedural obfuscations, as the Delaware Court tried in Bear Stearns.

By being explicit, law and macroeconomics can mitigate one important risk—that a different law in periods of macroeconomic turmoil will damage law when the economy is healthy. In Organization for Economic Cooperation and Development (OECD) countries, the default macroeconomic condition is stability. Most of the time, the economy grows, unemployment is relatively low, and inflation is at most a nuisance. “Aggregate demand”—the amount people want to buy—sits in rough balance to “aggregate supply”—the amount the economy can produce without overheating. In these conditions, macroeconomically-oriented law and regulation offers little. There is not much to fix, and law and regulation are ill-equipped to help. We do not want law in ordinary times, such as the ordinary law of shareholder coercion in mergers and acquisitions, to be adulterated with concern about the rare merger in which macroeconomics is a critical factor, like it was in Bear Stearns. An explicit reference to macroeconomic turmoil, combined with the relative ease of identifying financial crises, mass unemployment, and hyperinflation, means that explicit bifurcation by macroeconomic conditions should enable law to respond to critical macroeconomic needs without contaminating law in ordinary times.

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15 Yair Listokin & Inho Mun, Rethinking Corporate Law During a Financial Crisis, 8 HARV. BUS. L. REV. 349 (2018).

16 Outside the OECD, macroeconomic turbulence is more common. See, e.g., Pierre-Richard Agénor, C. John McDermott & Eswar S. Prasad, Macroeconomic Fluctuations in Developing Countries: Some Stylized Facts, 14 THE WORLD BANK ECON. REV. 251, 253 (2000) (finding that “output volatility is greater in developing countries than in industrial countries”). In these countries, law and macroeconomics will be particularly relevant. Indeed, in some countries, law and macroeconomics will likely surpass law and microeconomics in importance.
Of course, there will be boundary conditions in which the macroeconomy is neither plainly stable nor plainly subject to excessive unemployment or hyper-inflation. In these conditions, concerns about excessive stimulation and the general concern about lack of expertise looms largest. To return to our analogy, we do not want people with no expertise tending to a sick patient unless that patient is near death.

To this I say—let us start slow. At present, developed countries explicitly practice very little law and macroeconomics, though Margalioth describes an important counterexample of Israel in the 1980s. Instead, I think lawyers and regulators in industrialized and developing countries should begin to attend to macroeconomic conditions when they are at their worst—episodes of mass unemployment, hyperinflations, and financial crises. In these conditions, coarse attempts by lawyers and regulators to stimulate spending or decrease inflationary expectations are most likely to work, as they did during the Israeli economic crisis described by Margalioth. In more typical macroeconomic conditions, however, we should refrain from practicing law and macroeconomics for the reasons discussed by Webber. If law and macroeconomic reasoning succeeds in the most favorable circumstances, we can then consider expanding its application to more common macroeconomic scenarios.

17 There is one important exception to this rule—the law of central banking. Modern states have created extraordinarily powerful institutions, central banks, to manage both everyday macroeconomic turbulence and periodic crises. These institutions are desperately in need of a coherent legal framework to legitimate and improve their function at all times. As a result, law and macroeconomic interventions into central banking cannot wait for the next macroeconomic crisis. For a recent attempt along these lines, see Peter Conti-Brown, Yair Listokin, & Nicholas Parrillo, *Towards an Administrative Law of Central Banking* (working paper of file with author, 2019).