



Introduction to the special issue on the importance of *Simple Rules for a Complex World*

Shruti Rajagopalan¹ · Mario Rizzo²

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It is not often that a legal scholar begins a book by making their tribe superfluous. “Too many lawyers, too much law,” and so begins, Epstein’s *Simple Rules for a Complex World*. (1995, p.1) [hereinafter *Simple Rules*].

Having called out the problem of excess, Epstein sets out “to develop a set of simple rules capable of handling the most complex of social relations imaginable, whether in the United States or anywhere else.” (1995, p.21) The book argues that most legal relationships can be reduced to questions of individual autonomy, property acquisition, contract, tort, eminent domain, and taxation. For each of the six themes, Epstein details “a set of universal prescriptions whose intrinsic desirability is not tightly bound to the controversies of the day.” (1995, p.22).

This special issue of the *European Journal of Law and Economics* revisits and extends the themes in *Simple Rules*. The papers in this issue are the outcome of a conference at the Classical Liberal Institute at New York University, School of Law in 2020, to celebrate the 25th anniversary of the book’s publication. Over two days, lawyers, economists, and scholars working in law and economics, examined the book, its continuing relevance and possible extensions to new areas of law and economics, and offered new criticisms and extended it to other countries. Those discussions are brought together in the nine papers that are part of this special issue.

In law and economics, there is a large body of literature analyzing the “optimality” of specific rules in different fields of law. Epstein however argues that aiming for optimality, with individual rules for each situation, might lead to an overly complex system overall. In *Simple Rules*, Epstein argues that the complexities imposed by the American regulatory system create private costs of compliance, public costs of enforcement and social costs related to uncertainty which, in aggregate, are likely

✉ Shruti Rajagopalan
srajagopalan@mercatus.gmu.edu

Mario Rizzo
mario.rizzo@nyu.edu

¹ Mercatus Center at George Mason University, Arlington, VA, USA

² New York University, New York, NY, USA

to exceed the benefits from regulation and undermine the overall functioning of the market system.

Since its publication twenty-five years ago, the ideas detailed in Epstein's book have become an integral part of the economic analysis of the regulatory state in the US. He notes that all these criteria, and possibly others as well, can be reduced to a question about the costs of compliance.

This special issue begins with Mario Rizzo adding context to the idea of simple rules that go beyond low cost. Rizzo argues that "abstraction, and not "simplicity," is "the fundamental characteristic of rules for complex systems."

Further, rules may be ends-independent in the sense that they abstract from particular purposes of individuals (or the state). Thirdly, rules may be decomposable from either the environment or other rules within the same system. Fourth, rules may be general in their application, that is, they pass the test of consent under the veil of uncertainty, where individuals conceptually abstract from their own positions and thus determine whether they will be winners or losers from particular applications of the rule.

In other words, Rizzo brings in a Hayekian flavor and content to Epstein's idea of simple rules, to ensure that they are not just simple but also enable the rule of law in addition to low-cost predictability.

For Rizzo, simple rules are abstract, general, decomposable, predictable, and ends-independent. At the other end, Epstein argues that a rule is complex if the cost of compliance is high: "the minimum condition for calling any rule complex is that it creates public regulatory obstacles to the achievement of some private objective" (Epstein 1995, p. 27). This prompts Vlad Tarko to pose a question that cuts to the heart: Why are rules complex?

Tarko's paper posits that the crisis of legitimacy in capitalism owes to the complexity of rules. There are many reasons individuals, policymakers, experts, lobbyists etc. demand more complex rules to correct capitalism: (1) The uncertainty caused by creative destruction; (2) Inequality, as well as perceptions of justice, equity and progress in society; and, (3) Unrealistic expectations of growth, especially compared to the post WWII decades when economies boomed relative to now when growth is sluggish.

This problem of decreasing growth, Tarko argues, thus overlaps with the other problems of legitimacy. Low growth merely makes the current situation different than the previous crises of legitimacy because it limits the range of policies available to arrest these crises.

Even though the reason for complexity is the loss of legitimacy in capitalism, Tarko argues that solution is to simplify rules. Simple rules offer the institutional foundation for a high-growth society, and high growth in turn restores legitimacy. At the same time, simple rules provide a greater degree of fairness by eliminating the possibility of specially granted privileges—a fairness rooted in a concept of equality of opportunity rather than of equality of outcomes. Hence the relevance of simple rules in the current complex, polarized world.

Jesús Fernández-Villaverde's essay examines the new trend in modern capitalism, namely the increasing use of artificial intelligence (AI) and, in particular, machine

learning (ML), which has led many to argue that to design complex algorithmic rules that deliver social outcomes superior are to those from simple legal rules.

Fernández-Villaverde argues against replacing simple rules with AI/ML on three counts. First, AI/ML, and particularly ML, requires enormous datasets that are both expensive, and not comprehensive enough.

Second, he brings in the Lucas critique framework to argue for simple rules. Economic agents make decisions based on expectations about policy regimes. Thus, any variation in policy renders previous observations useless, unless a structural model complete with preferences, technology and information sets is available for the researcher to recompute the optimal responses to the new policy.

Furthermore, such a structural model should also incorporate policymakers' probability of changing the environment. By construction, ML has little to say about structural models as they are reduced-form statistical representations.

A third argument against replacing simple rules with AI/ML is Hayekian. The fundamental barrier that social organization faces is that information is dispersed, and agents do not have incentives or capabilities to disclose such information to a centralized mechanism such as an ML algorithm. Therefore, rules and institutions that can aggregate decentralized and dispersed knowledge are still required. Villaverde concludes that while ML is a handy tool, Epstein's case for simple rules is still sound. ML will never substitute first possession, voluntary exchange, and *pacta sunt servanda* as the basis of a legal system that delivers economic growth and welfare.

John Taylor's essay tracks the journey of a simple rule in a complex world of monetary economics—the eponymous Taylor rule—and compares it to Epstein's framework. In the early nineties, Taylor wrestled with the question: could a simple monetary policy rule be designed that could be responsibly recommended to policy makers in practice, while staying consistent with what research was telling us about the key properties of very complex optimal rules?

Taylor had described how monetary policy had been made in the past by reducing it to a simple set of relationships. He found that the policy interest rate needs only to react to two variables: (1) If the inflation rate moved away from the target and (2) If real GDP moved away from its potential. Making some realistic assumptions to benchmark both the inflation and GDP targets led to a simple equation, which came to be known as the Taylor rule.

Though this idea of a simple rule limiting discretion in the hands of the central bank gained a lot of currency, there has been a big departure since the period before the Global Financial Crisis and now during the Covid-19 pandemic. But for reasons similar to Epstein's—reducing the cost of uncertainty, discretion, complexity leading to unpredictability of central bank decisions—Taylor argues that simple rules still hold value in guiding monetary policy.

Much like the arguments countered by Taylor for the monetary system, Christopher Mufarrige and Todd Zywicki counter the argument that the complexity of modern finance is often thought to require an equally complex regulatory structure to preserve the safety of the financial system, making simple rules frameworks inapplicable. Especially in the wake of the Global Financial Crisis and the onslaught of

legislation and regulation that followed, the regulatory state has itself become more complex.

Mufarrige and Zywicki posit that the argument is exactly backwards. Simplicity in the regulatory framework is essential for financial institutions to manage risk and conduct their affairs efficiently and prudently. Complexity, by contrast, begets a variety of destabilizing problems, including the likelihood of regulatory arbitrage and errors by regulators that increase risk. Refashioning financial regulation around Epstein's concept of simple rules that are ends-independent will, they suggest, create a more stable and efficient financial regulatory system.

While using the fundamental argument of Epstein's book—low-cost predictability—Robert Miller examines another area of financial regulation, the exceptional case of insider trading. He argues that contracts between employers and their employees prohibiting insider trading fall into the unusual category of contracts with low search and bargaining costs but high enforcement costs. Against that, the cost of negotiating an employment agreement is generally low, and it is easy to include in such agreements a provision prohibiting the employee from trading on the information of the employer—a simple rule in operation.

Because of the extraordinary profits insider trading can bring, however, employees have a strong incentive to violate such a provision. And because the company has little ability either to detect violations or impose significant sanctions, the provision would go largely unenforced. In other words, contracts enhancing the welfare of both parties would be routinely breached by one of the parties because the other cannot effectively enforce the relevant penal provisions.

This reduces the value of the transaction to the parties and to society and, in extreme cases, will prevent the transaction from occurring altogether. But the government can both detect insider trading more effectively and punish it more severely than can private parties; therefore, government enforcement is likely an improvement, making insider trading regulation a rare case where a government ban may be superior to outcomes emerging from freedom of contract.

Charles Delmotte builds on Epstein's framework of simple and low-cost predictability of tax rules to further develop a radical simplification of income tax: the operationalization of a uniform expense rule. This means the application of a single deduction scheme across all expenses and investments. Delmotte argues that a stable and universal expense rule will narrow the scope of the politician's ability to concentrate benefits on special interest groups, and will limit rent-seeking.

Second, the abolition of deviating rules for investments will restrict the scope of tax optimization, and individual and corporate tax liabilities will be determined by the ability to pay them. The policy could save companies and government millions of dollars that they currently spend on tax compliance and on administration of the tax system respectively. And last, a deduction rule that applies across all businesses and industries would be less price-distortive, and thus will enhance the quality of the price signal.

Extending Epstein to developing countries, Shruti Rajagopalan and Alex Tabarok argue that the insights from *Simple Rules* are even more applicable to the 6 billion people living in states with weak states, where governance systems lack the capacity to enforce complex rules. First, complex rules are not fully enforced in

weak states, and there are unintended consequences of non-enforcement or arbitrary enforcement of existing rules. Second, creating and complying with these rules, even partially, imposes additional stress on the administrative and enforcement systems.

Consequently, there is premature load bearing, enforcement swamping, and increased subversion and corruption of the political and legal system—the under-recognized costs and consequences of a complex regulatory framework. Thirdly, because premature load bearing leads to poor consequences and too many violations, these states attempt to compensate for weak state capacity by imposing further complex regulations, especially with criminal penalties. Finally, prematurely adopting complex rules with limited state capacity can reduce the ability of weak states to develop greater state capacity. Using examples from India, the largest country with weak state capacity and complex rules, Rajagopalan and Tabarrok make a case for simple rules for the developing world.

Epstein has the last word in this special issue, and he begins by stating that his substantive views have not changed since the book was first written, except on some points of detail.

However, in his essay, he extends the arguments of his book in three ways. First, he explains how a single-owner model drives this basic set of entitlements under conditions of universal consent, which are not matched in a state of nature. He then explains how, when property rights derive from occupation instead of common ownership, a simplified set of entitlements offers the best path for incorporating the basic insights of the single-owner model.

When, however, one or more parties deviate from these entitlements, the needed remedial adjustments must overcome uncertainty in trying to choose the proper mix of damages and specific relief in varying contexts. Epstein argues that once that private law framework is settled, the central rule that governs the switch from private to public law should be that efficient entitlements should never be altered, but new remedial design should improve the private law model by reducing the transaction costs needed to operate the overall system.

Epstein has influenced the legal scholarship on the need, scope and limits of regulation, and also economics literature as well as law and economics literature. But despite his influence on the academic literature, regulatory complexity has only increased, making *Simple Rules* more relevant than ever. It is clear, moreover, that his insights can be extended to fields of development economics, macroeconomics and comparative capitalist systems. It is hard to predict whether the questions raised in this symposium will be resolved or reconciled, but one can confidently say that much more remains to be written and discussed on the themes emerging from *Simple Rules*.

We would like to take this opportunity to thank a few people. First, Richard Epstein for his wonderful book, and his contribution to this special issue. Thanks to Laura Crete and Aizhan Mitteldorf, who ensured that the conference ran smooth and seamless.

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Declarations

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