Regulation vs. Litigation: A comparative institutional perspective on blood markets*

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Abstract: Glaseser & Shleifer (2003) argue that regulation is pervasive in otherwise wealthy nations because it protects property rights more effectively than the court system can. This is the case because economic growth produces large firms and large firms face a lower cost per unit of output of subverting the court system and are therefore more likely to do so. We argue here that this argument overlooks three important insights from the Austrian and Public Choice literature. First, Glaeser & Shleifer’s (2003) analysis ignores the relative importance of the knowledge problem in different institutional contexts. Regulators are more likely than a decentralized system of courts to suffer from the knowledge problem and enforce an otherwise inefficient allocation of property rights. Second, regulation can create dynamic inefficiencies in markets while court enforced solutions to property rights disputes allow private parties to negotiate around any potential inefficiency and can therefore at worst create static inefficiencies. Finally, regulation can create incentives for the pursuit of additional destructive entrepreneurial rent seeking opportunities and produce a cycle of destructive entrepreneurial competition. We use the example of markets for blood to illustrate these three points.

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1. Introduction

The intricate relationship between legal and economic processes has been an area of interest to political economists since the publication of Adam Smith’s *Wealth of Nations* (1776). Smith famously said that “Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice” (Smith 1904[1776], I 56 C). Since Smith, the literature has often focused on alternative institutional solutions to the administration of justice and more specifically the choice between courts as administrators of the law as compared to legislation and regulation through the legislature and government bureaus.4

More recently, Glaeser & Shleifer (2003) develop a theory of law enforcement that essentially suggests that courts and government intervention are close institutional substitutes for the enforcement of property rights. More specifically, Glaeser & Shleifer (2003, 401) “develop a theory of law enforcement in which private litigation, government regulation, a combination of the two, and doing nothing are considered as alternative institutional arrangements to secure property rights.” They set out to show that under different conditions, different institutional arrangements will produce the most economically efficient outcome. Using evidence from the progressive era, they show that with increasing firm size private litigation becomes less effective at securing property rights, because larger firms have greater abilities to pay to avoid legal damages, and therefore subvert the legal system. As businesses influence the courts more frequently in their favor, property rights become less secure and regulation becomes relatively more attractive as an institutional solution. Glaeser & Shleifer (2003, pp. 404, 410) and Shleifer (2010) conclude that regulation is ubiquitous in otherwise wealthy nations around the world today, because it better

4 See La Porta et al. 2008 for a summary of the legal origins literature which distinguishes between systems that rely on the common law and courts for the resolution of disputes vs. systems that rely on legislation and litigation.
protects the property rights of the weaker parties relative to resolving disputes through the court system when firms become significantly larger.

In this paper, we suggest that while Glaeser & Shleifer (2003) at least nominally acknowledge the special interest theory of regulation and its compatibility with their model, the model ignores the systematic problems of the regulatory approach to securing property rights that have been identified by public choice scholars and Austrian economists over the years. More specifically, their approach is too optimistic for three reasons: First, their model ignores an important knowledge problem that regulators face. Private negotiations around a court-enforced property right can solve this knowledge problem more swiftly than the regulatory approach to dispute resolution. Second, what Glaeser & Shleifer (2010) fail to incorporate into their model is that when regulators pursue regulation for reasons other than to force producers to internalize negative externalities, regulation has costly unintended consequences that carefully tailored dispute resolution through private negotiations and courts cannot produce. Courts may change property rights assignments or prohibit specific types of conduct through injunctions, which both create wealth effects. When firms expend resources to undermine courts, they can therefore create static inefficiencies that benefit them temporarily. Regulatory agencies, on the other hand, can grant more extensive and persistent privileges to firms that lobby them. The public choice literature is rife with examples of regulatory monopolies, entry restrictions to limit competition, and other regulatory privileges that courts do not have the power to grant.

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5 Glaeser & Shleifer (2003) do acknowledge standard public choice theories and the theory of regulatory “capture,” which suggest that the motives of regulators are more complex than “public interest” theories let on (Stigler 1971, Posner 1974, Peltzman 1976, McChesney 1987, Becker 1983, Levine and Forrence, 1990). While they accept these theories as evidence for the fact that regulation (like the courts) can be circumvented by the regulated industry, they fail to incorporate the differential effect of regulatory capture as compared to court capture into their model. Regulation can create significant benefits for the firms in the regulated industry, which is ultimately why firms favor regulation over litigation. This perspective on the issue emphasizes the demand side of the rise of regulation rather than the supply side, which is emphasized by Glaeser & Shleifer (2003).

6 For a recent summary of the literature on the topic, see Shughart & Thomas (forthcoming). For specific examples see any of the following: Bartel & Thomas 1978; Dolar & Shughart 2012; Douglas & Miller
have dynamic consequences on the affected markets where courts can at worst create static inefficiencies that private parties can contract around should such action be economically efficient (Coase 1960).

Our third and final argument is that under certain circumstances regulation can degrade the incentives for productive innovation and instead increase the incentives for unproductive entrepreneurship (Buchanan 1980, Bhagwati 1982, Baumol 1990, Shleifer, 1998, Coyne et al. 2010). Regulation that benefits specific industries represents an incentive for producers in other industries to lobby governments for regulatory favors. As a result, such regulation has severe consequences for the direction and success of entrepreneurial discovery within an industry and therefore for the continued accumulation of societal wealth. When market forces are reined in artificially, productive entrepreneurship, as opposed to unproductive or rent seeking entrepreneurship, becomes relatively less profitable (Coyne et al. 2010). This change in the relative profitability of productive and unproductive types of entrepreneurship will result in more intervention and less innovation in the regulated industry. Regulated industries will be relatively stagnant and product quality and supply issues will persist.

We use the case of blood markets to illustrate our argument. Initially unregulated, blood markets were regulated during the 1960s and 70s on the state level through legislation that mandated limited liability for hospitals and blood banks. Such rules were adopted by 47 states, with the intention of providing a solution to the problem of hepatitis transmission through blood transfusion. We will show that while court decisions were moving in the direction of greater economic efficiency, regulation reversed this trend and resulted in a complete destruction of the
commercial blood market. We will show further that a strict liability regime, which courts in a few states had started to apply, seemed to be solving the problem of hepatitis transmission much better without eliminating commercial blood. The initial regulation of blood markets eventually resulted in a complete prohibition of commercial blood banks, while blood shortages persist to this day. This example underscores the idea that the rise of the regulatory state does not necessarily provide uniform improvements in efficiency, even when firm size increases.

The paper is organized as follows. We start out by reviewing the existing debate on legislation vs litigation as alternative institutional solutions to property rights disputes in section two. Section two also summarizes the property rights disputes that emerged in markets for blood when the relative incidence of post transfusion hepatitis became a topic of public debate. Section three suggests that courts were actually solving the property rights disputes that arose in blood markets quite effectively when regulators intervened and imposed a much less efficient solution to the problem that benefited the hospital lobby at the expense of patients and general market efficiency. This section also explains why regulation in the market for blood had more harmful long run consequences than resolution of property rights disputes through the courts. Section four suggests that accepting regulation as the primary solution to property rights disputes creates additional inefficiencies and potentially a vicious spiral of destructive lobbying entrepreneurship which might be the real reason for the rise of the regulatory state. Section five concludes.

2. Litigation vs. Legislation

To understand the continuing debate over the pros and cons of the judicial system vs. regulatory administration as alternative institutional solutions to property rights disputes, it is instructive to review the literature on the topic briefly. Warren Samuels, for example, in a paper that began an extended debate between James Buchanan and himself, treats legislation and courts as equivalent institutional solutions to property rights disputes that require the choice “between the effective
promotion of one group or the other” (1971, p. 441). Buchanan, in contrast, argues that legislation and courts cannot be treated as perfect substitutes for the resolution of property rights disputes primarily because government intervention cannot account for the willingness to pay of affected parties, which is only possible through private negotiations around an existing set of rights a la Coase (1960). In the debate between Warren Samuels (1971) and James Buchanan (1972), Samuels argued that no matter the outcome of a particular property rights dispute, the government had to choose and take sides by assigning property rights in one way or the other. He further argued that even if the status quo ante property rights regime was maintained, the government would be present “with respect to the already existing law of property working as it turned out to the advantage of the the original holder of the property right (Ibid, 441). Samuels' position was essentially that no matter the institutional regime, government would always play a role in picking winners and losers. James Buchanan, on the other hand, was reluctant to accept this conclusion and argued that the socially optimal outcome (efficiency) could not be achieved if government intervened to re-define property rights, because it had faced fundamental knowledge problem. Neither legislators nor bureaucrats could accurately account for the willingness to pay or accept compensation of either party involved in the property rights dispute. He suggested that private negotiations around the status quo property rights regime, a la Coase (1960), were the only means to achieving efficiency and internalizing all costs. From Buchanan's perspective, a status quo bias (Buchanan 2004) is necessary not because it is morally valuable but because it is the only system under which private bargaining can take place, which is essential to the revelation of economically relevant knowledge a la Hayek (1945). Otherwise, changing real world circumstances would always result in intervention and create uncertainty, which would fundamentally hamper economic activity.

The market for whole blood can be thought of in similar terms. Douglass Starr’s book, Blood: An Epic History of Medicine and Commerce (2000) describes the history of wild experimentation in
whole blood transfusion that shaped the early history of blood markets. Starr recounts the
evolution of blood transfusion from a desperate attempt to prevent shock on the battlefields of
World War II into a domestic peacetime industry where blood was recruited for the sake of
innovative life-saving surgical procedures. Blood transfusion inspired and developed alongside a
tremendous wave of progress in medicine in the middle portion of the 20th century.

Early on, the benefits of receiving a blood transfusion had clearly outweighed the costs of a
potential infection with post transfusion hepatitis. Post transfusion hepatitis did therefore not
receive much public attention. It was not until the 1960s that this problem with the extensive use of
transfusions received public attention. Hepatitis B, a disease that caused liver failure in some
portion of people who contracted the disease, was an unintended consequence of whole blood
transfusion. This problem was a nuisance that was tolerated as long as whole blood transfusion was
associated with the tremendous increase in the number of life-saving procedures. Considering that
there was no screening test for hepatitis B until 1974, the risk in the 1960s was clear: the
probability of receiving a whole blood transfusion containing hepatitis B would interact with
probability of developing liver disease as a result of exposure to the virus.

As long as there was no way to screen for hepatitis, the risks of receiving blood transfusions
were incorporated into the cost calculus of individuals that required blood transfusions. In 1966,
new information was discovered however. J. Garrott Allen of Stanford University Hospital
published a short article linking the commercial blood market with hepatitis transmission rates
that were 10 times higher than comparable rates from voluntary recruitment. Commercial blood
donors were more likely than volunteer donors to be from lower income classes, had a higher
incidence of alcohol and drug dependence and were therefore also more likely to suffer from

10 Baruch Samuel Blumberg developed a Screening test for Hepatitis B and shared the 1976 Nobel
11 See also Jones et al. (1971): 1/20 who received commercial blood could contract serum hepatitis, while 1/200 from voluntary blood.
hepatitis in the first place. Because of this adverse selection problem he identified among for-profit blood banks, Allen (1966) advocated for the elimination of markets in blood for the improvement of patient health. The medical community initially ignored Allen’s arguments, but the issue he had uncovered became a central feature of Richard Titmuss’s 1970 book, The Gift Relationship: From Human Blood to Social Policy. In his book, Titmuss generalized the argument that markets corrupted and that Allen’s finding was evidence of this pathology in the United States health care system where rates of hepatitis transmission were far higher than in the United Kingdom.

These arguments eventually led to a strong critique of blood markets and the regulation of the industry by the Food and Drug Administration (FDA). In 1974, the FDA regulated the blood industry by applying a relatively simple blood labeling system. The units of whole blood which were recruited through commercial means, i.e. paid donors, were labeled commercial blood. Hospitals were strictly liable for any cases of post-transfusion hepatitis that were the result of a hospital’s use of this type of blood, which was often recruited by blood banks. The units that were recruited from voluntary donors were labeled voluntary. Hospitals were only liable for cases of post-transfusion hepatitis that resulted from their use of this type of blood, if they had not taken due care in their handling of the blood. A third category was labeled autologous donation, which was blood taken from the patient up to a week in advance of a procedure and transfused back to the same patient. As a result of this labeling law and the differential legal treatments of the different types of blood, the market for whole blood disappeared almost completely. No hospital was willing to take the risk of being strictly liable in cases of post-transfusion hepatitis that resulted from their use of commercial blood.12

Prima facie, the case of the market for blood seems to suggest that regulation was the efficient response to the failure of blood banks to account for the knowledge of the higher incidence of hepatitis transmissions for blood recruited from higher-risk populations. Despite the publication

12 Plasma markets were unaffected by this legal development, because plasma could be pasteurized to prevent viral transmission.
of Garrott Allen’s study in 1966, blood banks had not adopted any screening techniques by 1974 when the FDA stepped in.

...to the courts could have established a property rights regime that could have reduced the differential risk of commercial blood if they had adopted a strict liability standard that would have encouraged blood banks to adopt better ex-ante screening techniques. The fact that this did not happen gives some reason to side with Warren Samuels, however, and favor legislation. While Buchanan maintained that private negotiations around the status quo would eventually produce the most efficient outcome, the argument favoring intervention had important voices on its side: Samuels (1971), Allen (1966), Titmuss (1970), and even other economists like Robert Solow (1971) weighed in on the debate.

Were we left only with this version of the story, we would conclude two things: 1) The efficient outcome could potentially be reached through either courts or legislation, but 2) in line with Glaeser and Shleifer’s (2003) argument the case of the market for blood suggests that clear regulation can more quickly resolve an existing dispute over property rights. Edward Glaeser and Andrei Shleifer’s (2003) article suggests that this might be the case because large businesses have an easier time subverting the court system to decide property rights disputes in their favor, which would suggest that regulation is the more efficient institutional framework as businesses grow larger. We briefly review their argument in the next section of this paper and then show that the opposite was the case in the market for blood. While the courts were moving in the direction of solving the problem that had been caused by hepatitis in the market for blood, regulatory agencies enforced a static solution to the problem that ultimately eliminated the commercial market for whole blood.
3. Subverted Regulation

In their paper, “The Rise of the Regulatory State” (2003), Edward Glaeser and Andrei Schleifer explore the effectiveness of different institutional arrangements for the resolution of property rights disputes in the context of increasing business size. More specifically, they argue that regulation arose during the progressive era because of a question surrounding the ability of courts to adjudicate fairly between large powerful corporations and private individuals. Glaeser & Shleifer (2003) and Shleifer (2010) argue that during the progressive era, the court system became widely used to privilege corporations that faced declining average cost of influencing the outcome of litigation per unit of output. In light of this critique, corporations came under scrutiny and regulation became more prevalent. This story emphasizes an efficient institutional response when the court system breaks down: more regulation. Ultimately, Glaser & Shleifer (2003) suggest that both regulatory fines and court damages provide an incentive for firms to engage in greater levels of precaution and therefore to minimize the social cost of production. As countries are populated by more powerful corporations, as is common in the western world’s economies, regulatory oversight grows.\(^\text{13}\) Their theory assumes what has yet to be proven and what may not be uniformly the case, that regulation is a more effective means of resolving property rights disputes when firms are large.\(^\text{14}\) Glaeser and Shleifer’s argument suggests that as societies get wealthier, larger firms will spend more money (in absolute terms) to subvert the rule of law in their favor. In short, they define the progressive era as an efficient response to the failure of the court system to effectively secure property rights. In their view, “the theoretical analysis points to a fundamental change that made it

\(^{\text{13}}\) An alternative theory of regulation, the economic or interest group theory of regulation, suggests that regulation is the result of lobbying efforts by the regulated industry itself (Tullock 1967; Stigler 1971; Peltzman 1989). According to this theory, regulation is imposed to benefit a relatively small politically focused group, producers, at the expense of a politically diffused group, consumers. Shleifer & Glaeser (2003) conclude that their model is not in conflict with the interest group theory of regulation, but that efficiency improving regulation can be consistent with it.

\(^{\text{14}}\) It also assumes that a general rule is a direct substitute for the imposition of damages through courts who are forced to render decisions based on the specific details of a case.
efficient for American society to increasingly rely on regulation” (p. 402). This argument builds on Warren Samuels’ arguments which we explored in the previous section, but it adds the important nuance that the preference of wealthy nations for intervention is a function of economic growth. Glaeser & Shleifer (2003) suggest that regulation and litigation are alternative institutional arrangements for the resolution of property rights disputes, but that regulation is more difficult to subvert as firm size increases and therefore becomes the efficient choice in advanced economies. The following example challenges this assertion and shows how, in the case of the market for whole blood, the regulatory regime came with significant institutional disadvantages that Shleifer and Glaeser’s model fails to account for. This suggests that their analysis is incomplete and therefore inconclusive.

3.1 Regulation and Knowledge

In his response to Warren Samuels (1971), James Buchanan (1972) notes that legislated solutions will always face a knowledge problem and that “only when transfers are actually made can relative values be measured by those whose interests are directly involved” (p. 442). In this section, we build on Buchanan’s argument and suggest that regulation is often inferior to negotiations around an existing set of property rights potentially aided by courts, because it cannot incorporate knowledge about individual valuation of different potential outcomes effectively. Take blood markets as an example. A person in a medical emergency situation may be willing to take the risk of contracting serum hepatitis after obtaining a blood transfusion from a commercial blood bank because doing so would still extend his life and allow him to avert death. After regulation of blood markets essentially outlawed commercial blood, however, this was no longer an option and there have been blood shortages ever since. We argue in what follows that FDA regulation of

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15 If we take this statement to suggest that there is a monotonic trend of increasing regulation as a function of greater wealth in a society, then regulation is not merely a luxury good, but the most efficient option for the legal system of advanced economies.
markets for blood faced a systematic knowledge problem and ignored individual valuations of different sources for blood. It ultimately produced an outcome that, while potentially efficient in the short run, has plagued blood markets in the United States since its implementation.

Our discussion so far suggests that there was a pathological sclerosis in the property rights regime for whole blood before FDA intervention in 1974. Hepatitis transmission rates for blood from paid donors were 10 times higher than the same rates for volunteer blood, but the courts had decided in favor of a due care standard for hospitals leaving patients to bear the full cost of transfusion hepatitis and destroying any possible incentive for hospitals or blood banks to implement screening techniques that could have effectively lowered the number of hepatitis cases. This description of the state of markets for blood overstates the case for regulation, however, because it does not account for developments in the courts that would have resolved the problem in a way that may have both solved the hepatitis transmission problem while keeping markets for blood in tact. In fact, an efficient legal solution that would have allowed for blood markets to continue existing alongside blood donor agencies was beginning to emerge as early as 1965. In 1965, blood law benefited from doctrinal changes that had led to a reversal of the existing precedent of due care in cases of post-transfusion hepatitis. The restatement of section 402A of Torts by the American Law Institute (ALI) provided for a more widespread application of strict liability for products. ALI, which was founded by a group of judges, lawyers, and teachers in 1923, publishes "scholarly work to clarify, modernize, and otherwise improve the law." The ALI's restatement of torts recommended that “One who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property” (ALI 1965). In the market for blood, the application of this insight would have created a greater incentive for blood

16 See www.ali.org for a description of the history and purpose of the American Law Institute.
banks to screen for hepatitis even in the absence of a hepatitis test, by simple application of a few ex-ante screening techniques that would have identified the most risky donors.

Ruben Kessel commented on this doctrinal change in a 1972 paper, suggesting that a return to the strict liability standard would reform blood markets in much the same way as the broader product liability literature suggested. This was not simply academic, however. The new liability standards would ultimately incentivize the discovery of knowledge of what caused serum hepatitis and push blood banks in the direction of more effective screening techniques for donors with differential levels of the pathogen. Blood from the Mayo Clinic was already well known for having low levels of serum hepatitis, because the clinic recruited from a rural and relatively high-income pool of donors (need citation). Other blood banks could have easily implemented similar screening techniques that would have allowed them to reduce the hepatitis incidence among their donor pool even in the absence of a hepatitis test.

Legal research on the topic of post-transfusion hepatitis had concluded as early as 1970 (Calabresi and Bass, 1970) that a strict liability rule would be the more appropriate rule in the case of blood transfusions, because a strict liability regime would align incentives such that the development of more rigorous tests for hepatitis would be encouraged. Kessel (1972) similarly concluded that strict liability was the appropriate rule, because hospitals and physicians were the Coasian least-cost avoiders, and better equipped than individual patients to overcome informational asymmetries between blood donors and recipients. Essentially, a strict liability rule enforced by the courts was expected to elicit the best use of the knowledge about donor populations that already existed tacitly in the market for blood and, in addition, such a rule would provide the greatest incentive for innovation to remedy the problem of hepatitis transmission altogether.

Franklin, (1972, p. 462) distinguishes between three different rationales for strict tort liability in cases of post-transfusion hepatitis: First, the safety incentives rationale, which "asserts
that the person marketing the product should be forced to take into account the accident costs associated with that product... [because of] the defendant’s knowledge of, and access to, the intricacies of alternate product designs and production techniques.” In the case of markets for blood, blood banks in particular had knowledge about their donor population and could have improved the quality of the donor pool through better screening techniques or by moving to an alternative location that attracted a different donor profile. Similarly, hospitals and physicians have more information about the quality of blood coming from different blood banks than the recipient of a transfusion and are better able to judge safety. Often, hospitals functioned as blood banks, which meant that they did not only have a lot of knowledge about the donor population, but beyond that strict liability would have presented an incentive for them to expend additional resources on research to develop a hepatitis vaccine or a more reliable hepatitis test.17

Second, the resource allocation justification holds that prices should reflect the true cost of a product. “If social costs are not reflected in prices, then there will be excessive demand for underpriced products and the overall allocation of resources throughout society will be distorted.”(Franklin 1972, p. 463). Essentially, whole blood could be obtained at a price that did not reflect the cost of post transfusion hepatitis and, as a result, was inefficiently allocated and used even in cases when an additional transfusion was medically unnecessary.

Franklin called the third justification for a strict liability regime loss spreading. According to this rationale, it is desirable to spread the cost of post-transfusion hepatitis incidents across a large number of people “in order to minimize its impact on each individual” (Franklin 1972, 24 (3): 463). Such spreading of losses would best be achieved by producers of blood, i.e., blood banks and

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17These knowledge arguments are closely related to Buchanan’s (1972) criticism of legislation in his debate with Warren Samuels, which suggests that only when parties are left to negotiate contractual solutions to property rights disputes will the eventual resolution incorporate an accurate assessment of the cost of any potential damage to the parties. Buchanan’s argument is ultimately based on F.A. Hayek’s (1945) insight that the market process solves a fundamental knowledge problem that results from the fact that knowledge in the economy is dispersed and specific to time and place, which makes economic planning essentially impossible.
hospitals, through liability insurance that can be transferred to customers in the form of higher prices. The consistent application of a strict liability standard as favored by ALI would have implemented all three of Franklin's incentives and ultimately mediated the hepatitis transmission problem.

The ALI's (1965) restatement of torts recommended that “One who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or to his property.” Following this restatement strict liability was accepted as the appropriate rule in the 1969 case of Cunningham v. MacNeal Memorial Hospital by the Illinois Supreme Court and additional tort claims were decided in favor of the plaintiff. Table 1 gives a list of cases in which a strict liability rule was applied in favor of the plaintiff. These cases establish the fact that strict liability was emerging as the appropriate liability rule in the courts.

<table>
<thead>
<tr>
<th>Case</th>
<th>Deciding Court</th>
<th>Year</th>
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<tbody>
<tr>
<td>Russel v. Community Blood Bank, Inc.</td>
<td>Florida Appeals</td>
<td>1967</td>
</tr>
<tr>
<td>Hoder v. Sayet</td>
<td>Florida Appeals</td>
<td>1967</td>
</tr>
<tr>
<td>Cunningham v. MacNeal Memorial Hospital</td>
<td>Nebraska 2d</td>
<td>1969</td>
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<tr>
<td>Carter v. Inter-Faith Hospital</td>
<td>Supreme Court</td>
<td>1969</td>
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<tr>
<td>Hoffman v. Misericordia Hospital</td>
<td>Pennsylvania Appeals</td>
<td>1970</td>
</tr>
<tr>
<td>Jackson v. Muhlenberg Hospital</td>
<td>New Jersey Appeals 2d</td>
<td>1969</td>
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Despite this move of the courts in the direction of a strict liability rule after the restatement of torts, and despite the widely acknowledged greater efficiency of such a regime among legal scholars, the court’s decision in Cunningham v. MacNeal Memorial Hospital came under attack from the medical community immediately following its publication. From an interest group perspective, the medical community preferred a different property rights regime that excluded it from any responsibility. Hospitals therefore lobbied for a due care provision on the basis of being non-profit medical institutions which relegated complete responsibility to the for profit blood banks.

18 (Franklin 1972, fn.212)
A negligence standard or due care provision protects the retailer from flaws contained in a product at the time that the retailer received the item. For example, if under a due care standard a retailer received a product, placed it on the shelf, and sold it to someone who is later injured by the product, negligence on the part of the retailer would have to be demonstrated for the injured individual to receive compensation from that retailer. The retailer would be protected by the fact that they did nothing to contribute to causing the injury. The liability would pass to the manufacturer. In blood markets, a similar dynamic served to protect hospitals and negligent blood banks at the expense of consumers.

Armed with Allen’s (1966) evidence and Titmuss’ (1970) argument, the Illinois Medical Society together with the Illinois Hospital Association lobbied the state government to overturn the court ruling and advocated for a negligence rule, that would return the legal regime to its previous status quo of holding producers of blood liable only in cases of negligence (a return to a due care standard). Dr. James Hartney, an Illinois Medical Society trustee and former hospital laboratory director, led the effort and presented a draft bill establishing a negligence rule in a press conference on January 3rd 1971. Supported by editorial endorsements of the draft bill on January 5th and March 12th in the Chicago Tribune, the bill was picked up and sponsored by State Senator Robert Juckett [R], approved by the house judiciary committee in early March, and passed by a 157 to 2 vote by the Illinois House of Representatives on March 18th 1971, a mere 5 months after the court decision that had found a regional hospital strictly liable in a case of post-transfusion hepatitis.

Similar scenarios unfolded in other states around the country: Before 1965 only three states had reached a determination of legal status on the subject. By 1972, 41 states regulated liability such that it was limited to negligence; most of the statutes were implemented after the Cunningham Decision in 1970, which had found the defending hospital strictly liable. For a list of states that implemented legislation regulating liability to negligence only after 1970 see Table 3
below. In 1972, only 9 states remained for which liability for hepatitis transmission was regulated under the common law (Franklin 1972, p. 474).

Table 3: Statutes enforcing due care standard in cases of hepatitis transmission

<table>
<thead>
<tr>
<th>State</th>
<th>Year</th>
<th>Statute/Code</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arkansas</td>
<td>1971</td>
<td>S.B. 89</td>
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<tr>
<td>Hawaii</td>
<td>1971</td>
<td>Hawaii Rev. Stat. ch. 327</td>
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<tr>
<td>Nevada</td>
<td>1971</td>
<td>A.B. 227 (Nev. 1971)</td>
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<tr>
<td>North Dakota</td>
<td>1971</td>
<td>H.B. 1326 (N.D. 1971)</td>
</tr>
<tr>
<td>New Mexico</td>
<td>1971</td>
<td>[1971] N.M. Laws, ch. 119, §1</td>
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These developments in the market for blood show that while the courts were moving in the direction of an efficient resolution of the property rights disputes surrounding post transfusion hepatitis, which would have left markets for blood intact, the legislated solution, which was implemented in 1974, eliminated blood markets completely.

3.2 Regulation: Static vs. Dynamic Efficiency

In 1974, the FDA mandated a blood labeling system for the blood industry, which distinguished blood by the manner in which it was recruited. Units of whole blood that were recruited through commercial means, i.e. paid donors, had to be labeled “commercial blood.” If a
patient contracted post-transfusion hepatitis after a transfusion that included commercial blood, the hospital in which the transfusion had taken place was strictly liable. When blood was donated by volunteer donors, it was labeled “voluntary.” As long as a hospital could show that it had taken due care in its handling of this type of blood, it was not liable for any cases of post transfusion hepatitis that resulted from blood labeled voluntary. “Autologus” blood was blood that had been taken from a patient up to a week in advance of a procedure and transfused back to the same patient. The market for whole blood disappeared almost completely after this labeling law was put in place, because hospitals were no longer willing to take the risk of being strictly liable in cases of post-transfusion hepatitis.19 This intervention ultimately created a situation of perpetual blood shortages that persists to this day.20 To outlaw commercial blood, which was associated with a higher incidence of hepatitis transmissions, may have been the statically efficient solution, but it came at the cost of perpetual dynamic allocation problems in the market for whole blood.

Sullivan et al (2007) provide survey data for 2001 describing the production and consumption of blood in the United States. They report that 138 of 1086 hospitals (12.7 percent) reported cancellation of elective surgeries due to blood shortages on one or more days during 2001, with a median number of days of cancellations of 2. The total number of patients affected by such cancellations was 952. Another piece of evidence that supports the idea that blood markets in the United States are plagued by chronic shortages is the fact that the US has been a net importer of whole blood since the mid 1970s (Simon 2003: 273).

While it is impossible to calculate the costs of such persistent shortages with any accuracy, we content that they by now exceed the cost of a delay in a reduction in the number of post transfusion hepatitis cases. An antigen for hepatitis B already existed and hepatitis A vaccines were discovered shortly after FDA regulation of blood markets took effect. These technological break-

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19 Plasma markets were unaffected by this legal development, because plasma could be pasteurized to prevent viral transmission.
20 In February 2014, blood shortages again became national news (Yorke 2014). This was attributed to the winter cold, but last summer there was another push to limit bans on gay males donating blood (Stern 2013).
troughs essentially eliminated the threat that blood transfusions from paid donors posed. But paying donors for blood donations was no longer a viable option because no hospital would use commercial blood due to its relatively unfavorable legal standing. This legal differentiation between different blood sources resulted in chronic blood shortages that have persisted for almost 40 years now. We have paid dearly to solve a short run problem by imposing a cost on patients that has lasted into perpetuity.

4. Why Regulation is a bad default strategy

The case of the market for blood illustrates well that Buchanan's concern about the status of the status quo in the resolution of property rights disputes matters. Contrary to what Glaeser's and Shleifer's (2003) model would predict, the courts were well on their way to establishing an effective solution to the transfusion hepatitis problem, which would have incentivized blood banks and hospitals to screen their donor populations more effectively and reduce the number of post transfusion hepatitis cases, when regulators stepped in and implemented a solution that favored producer interest. Intervention based on the medical communities complaints and lobbying efforts was accepted as legitimate and the regulators efforts were unquestioned.

The vision which associates regulation with efficiency (Becker 1983), also called the "public interest theory of regulation; Levine and Forrence, 1990) has become an important starting point for thinking about solutions to social issues. We read market failure into many places where the market is not functioning correctly but could be functioning well given the development of clear property rights (Coase 1960). But Samuels' (1971) assumption that the end result of litigation is similar to legislation, but that legislation is often the more efficient of the two processes shortchanges the inherently dynamic character of markets. When legislation or regulation rather than private negotiations and courts become the default solution for the resolution of property rights disputes, the resources of society are redirected towards the extraction of resources and
rents by powerful interest groups such as the medical community in the case of blood markets. Baumol (1990) calls this unproductive entrepreneurship and Coyne et al. (2010) suggest that when unproductive entrepreneurship is institutionally rewarded, an unproductive entrepreneurial process follows that results in greater rent seeking costs to society.\textsuperscript{21}

Coyne et al. (2010) suggest that destructive political entrepreneurship that aims at political rents, can have a multiplier effect and open up additional opportunities for destructive entrepreneurship in the same industry, or even be replicated by other industries. Such a case is observed in the appeal by the Illinois Medical Society described above. In the case of blood markets in Illinois, the lobbying for regulation of the liability regime led to the creation of the Metropolitan Chicago Blood Council (MCBC), which was established by the Chicago Medical Society, the Chicago Hospital Council and the Mid-America Chapter of the American Red Cross.

The council’s self-proclaimed aim was to coordinate the collection and distribution of blood by the city’s blood banks, which included commercial blood banks, who were not represented on the council. Furthermore, the council’s intention was to increase the supply of volunteer blood and to “reduce the cost of transfusion by eliminating the need for so-called professional donors.”\textsuperscript{22} In September 1971, the council received $10,000 from Illinois Governor Oglivie, which were drawn from public health funds, to start a recruiting program for voluntary blood donations. This program was greatly aided in its efforts by publicity from a Chicago Tribune series on the high incidence of hepatitis transmission through commercial blood, titled \textit{Task Force Report}. The Blood Brother’s initiative was launched just 5 days after the last article in the Task Force series was published on September 16\textsuperscript{th}. The Chicago Tribune supported the effort of the MCBC further by publishing its pledge card on September 22\textsuperscript{nd}, which readers of the newspaper were encouraged to mail to the

\footnotesize{\textsuperscript{21} Buchanan (1980) first suggests that rent seeking activities by one firm can lead to an increase in the overall prevalence of rent seeking activities as other firms become aware of the profitability of such activities.}

\footnotesize{\textsuperscript{22} Dr. James B. Hartney chairman of the Chicago Medical Society’s committee on blood banks as cited in the Chicago Tribune, April 24\textsuperscript{th} 1971, pg. N\_A31 “Plan to Cut Blood Costs Told” by Ronald Kotulak.}
council. Stirred on by the MCBC’s efforts to collect more volunteer blood, Governor Oglivie, signed a bill into law, which outlawed commercial blood completely for the state of Illinois on August 18th, 1972.

The Chicago Medical industry had turned an initial defeat, which began with the Illinois Supreme Court ruling against McNeal Hospital in October 1970, into legislation reversing the court decision just 5 months later. Following this victory, James B. Hartney, the chairman of the medical society’s Committee on Blood Banks, had also secured a monopoly position for volunteer blood banks in the state just 17 months after the initial regulation. Within less than two years, commercial blood banks in Illinois had been outlawed through the efforts of political entrepreneurs like James B. Hartney, State Senator Robert S. Juckett, and Illinois Governor Oglivie. Each of them benefited individually either indirectly through media attention and association with the project, as in the case of the two politicians, or directly by capturing rents for his industry, as in the case of James B. Hartney.

In addition to leading to further regulation, the initial intervention into blood markets also stifled productive entrepreneurship. After the court decision, incentives for the medical profession to account for the increased hepatitis infection rate from commercial blood sources were again minimal.

The prohibition of commercial blood, while effectively destroying the existing market for blood, was a second best way of alleviating the existing hepatitis problem. While a strict liability regime would have resulted in better blood management and more informed decision making on the part of the medical profession, a negligence regime paired with the prohibition of commercial blood achieved a similar result: the hepatitis incidence fell. The regulatory regime also created blood shortages, however, which persist to this day.

Eventually this restriction of commercial blood in states like Illinois was replicated at the national level by the FDA, which gained purview over regulation of the medical use of whole blood.
By effectively establishing a due care standard for volunteer blood and a strict liability standard for commercial blood, the market for commercial blood disappeared. The medical industry, with the help of rule changes pursued by folks like Governor Oglivie, altered the rules of the game and the nature of payouts. This case suggests that where unproductive entrepreneurship through regulation is rewarded, regulation will not only subvert the most efficient outcome as may be the case when the courts are subverted. Regulation has additional dynamic unintended consequences on the market in question that are difficult to reverse or predict.

Glaeser & Shleifer (2003), who include the idea of the economic theory of regulation and regulatory capture in their model (Stigler 1971, Posner 1974, Peltzman 1976, and McChesney 1987), fail to incorporate this dynamic critique of interventionism which suggests that regulation changes the rules of the game for players looking to subvert the efficient outcome and systematically creates benefits for powerful interest groups who, as a result, become ever more influential.

5. Conclusion

Not only do regulators face important knowledge problems that a decentralized judicial system can address more effectively, accepting regulation as the status quo solution to property rights disputes comes with an inherent bias towards powerful interest groups.

We have shown that in the market for whole blood, legislation merely provided the ground for renewed and more lasting subversion by the same concentrated interests than the courts had provided. Beyond this, we have argued that the preference for legislation betrays a methodological commitment to viewing property rights dispute resolution regimes as subject to Stigler's (1961) search costs rather than Hayekian (1945) knowledge problems.23 As Buchanan (1972, 443) aptly

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put it: “only when transfers are actually made can relative values be measured by those whose interests are directly involved.” This follows the line of reasoning advanced by Coase (1960) and D. Friedman (Laws Order, p. 45) that absent relatively high transactions costs, victims should collect damages rather than third parties. Put differently, only individual patients or their doctors weighing the expected costs and benefits of additional blood transfusions are in a position to decide whether the risk of hepatitis transmission in any given case is too large to justify the use of commercial blood. In many cases, the expected cost-benefit calculation wouldn’t justify the use of commercial blood, but in some cases it would. By removing the option of using commercial whole blood completely through legislation, a lower than efficient number of total blood transfusions are administered. When we consider knowledge and importantly local knowledge as opposed to information that may be discovered by an expert like Garrott Allen or Richard Titmuss, we adopt a more dynamic approach to the legal-political nexus.

Finally, and as we have argued above, FDA regulation in this case appears to have been captured by medical community to provide due care protection to its member organizations. Property rights that were governing the whole blood industry had been ill-defined during the early 20th century and a higher rate of risk was tolerated than what seemed to be socially optimal. The question of which mechanism for clarifying property rights was better for the whole blood market is not clearly answered by the intervention of the FDA, however. The example of markets for blood, contradicts Glaeser & Shleifer (2003)’s theory of court failure leading to regulation and instead suggests an alternative motivation for regulation. When courts were moving in the direction of greater efficiency, regulation that catered to special interests was imposed and reversed this trend.
References


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