Posner, Richard A.

Working Paper

The Economics of Privacy

Working Paper, No. 16

Provided in Cooperation with:
George J. Stigler Center for the Study of the Economy and the State, The University of Chicago Booth School of Business

Suggested Citation: Posner, Richard A. (1980) : The Economics of Privacy, Working Paper, No. 16, The University of Chicago, Center for the Study of the Economy and the State, Chicago, IL

This Version is available at:
https://hdl.handle.net/10419/262418

CENTER FOR THE STUDY OF THE ECONOMY AND THE STATE

WORKING PAPER SERIES

THE ECONOMICS OF PRIVACY

Richard A. Posner*

Working Paper No. 016

October 1980

CENTER FOR THE STUDY OF THE ECONOMY AND THE STATE

The University of Chicago
1101 East 58th Street, Chicago, Illinois 60637

*Lee and Brena Freeman Professor of Law, University of Chicago Law School.

Revised
September 8, 1980

THE ECONOMICS OF PRIVACY

Richard A. Posner

The concept of "privacy" has received a good deal of attention from lawyers, political scientists, sociologists, philosophers and psychologists, but until recently very little from economists. This neglect is on the mend (see, e.g., Posner 1978, 1979a, and 1981, chs. 9-11; Stigler 1980), and in this paper I will report on the economic research on privacy in which I and others have been engaged.

Some definitional clarification is necessary at the outset. "Privacy" is used today in at least three senses. First, it is used to mean the concealment of information; indeed, this is its most common meaning today. Second, it is used to mean peace and quiet, as when someone complains that telephone solicitations are an invasion of his privacy. Third, it is used as a synonym for freedom and autonomy; it is in this sense that the Supreme Court has used the word in subsuming the right to have an abortion under the right of privacy (see Posner 1979b, pp. 190-200).

The third meaning of privacy need detain us only briefly. To affix the term "privacy" to human freedom and autonomy (as in Hirshleifer) is simply to relabel an old subject—not to identify a new area for economic research. The second meaning of the word privacy set out above invites a slightly novel application of economics. It suggests an economic reason why certain (cerebral) workers have private offices and other (manual) workers do not, why aversion to noise is associated with rising education, and why certain low-level invasions of a person's "private space" (e.g., shoving a person roughly but without hurting him) are tortious (see Posner 1981, ch. 10). But the range of economic applications in this area seems limited.

The first meaning of privacy set out above--privacy as concealment of information--seems the most interesting from an economic standpoint. There is a rich and growing literature on the economics of information. It would seem that the same economic factors that determine search behavior by workers and consumers might also determine investments in obtaining, and in shielding, private information. This insight (emphasized in Posner 1978) provides the starting-point for the economic analysis of privacy.

To relate the economics of privacy to the economics of information in as clear a fashion as possible, consider the example of the employer searching across employees and the employee searching across employers. The employer is looking for certain traits in an employee that may not be obvious, things like honesty, diligence, loyalty, and good physical and mental health. To the extent that the employee is deficient in one or more of these characteristics, he has an incentive--strictly analogous to the incentive of a seller of goods to conceal product defects--to conceal these deficiencies. That is, he has an incentive to invoke a "right of privacy" if the employer tries to "pry" into his "private" life.

The concealment of personal characteristics in the employment context retards rather than promotes the efficient sorting of employees to employers. By reducing the amount of information available to the "buyer" in the labor market (the employer), it reduces the efficiency of that market. The analysis can easily be generalized, moreover, to other markets, some of them "noneconomic," in which private information is concealed. An example is the marriage "market." The efficient sorting of females to males in that market is impeded if either spouse conceals material personal information. The extended courtship that remains typical of the marriage market may be due in part to

the efforts of prospective spouses to conceal their deficiencies from each other. The length of the courtship is a social cost of concealment in the same way that additional investment in search by buyers is a social cost of fraud by sellers of goods.

The idea that fraud in "selling" oneself is just like fraud in the sale of goods is resisted on various grounds. It is sometimes argued that people will misuse private information--will attach excessive weight to knowledge that a prospective employee has a criminal record, or is a homosexual, or has a history of mental illness. However, the literature on the economics of nonmarket behavior suggests that people are rational even in nonmarket transactions such as marriage, and, in market transactions, even in regard to such apparently emotional factors as race and sex (see, e.g., Becker, Phelps). Therefore, there seems to be no solid basis for questioning the competence of individuals to attach appropriate (which will often be slight) weight to private information--at least if "appropriate" is equated with "efficient."

Various other arguments are made against the view that concealment of personal information is a form of fraud. It has been argued that such concealment provides a form of social insurance, by buffering the wealth consequences of ill health, social misconduct, and other things that reduce wealth, since concealment may prevent the full wealth consequences of his condition or history from being visited on the individual (see Shavell). But concealment of adverse personal characteristics is surely an inefficient method of insurance; rather than spread costs widely, it shifts them from one small group to another. To take an extreme example, suppose that a teacher is allowed to conceal a history of sexual assaults on schoolchildren. The costs of concealment-as-insurance in this instance will not be spread

throughout a large group but will instead be concentrated on the school-children who become victims of this teacher in the future as a result of their (and the school board's) ignorance of his propensities.

It is also argued that disclosure of personal misconduct throws out of whack a carefully calibrated system of criminal sanctions; it increases the punishment for the crime, and reduces the prospects for rehabilitation of the criminal. But to foster concealment of a criminal past is to reduce the efficiency of the market for ex-criminals. It is more efficient to reduce sentences, or encourage rehabilitation by cash payments to the successfully rehabilitated criminal, than to force those who deal with the ex-criminal to do so in darkness.

More troubling to me is the argument (in Easterbrook) from information overload. It is costly to assimilate heavy doses of information, much of it concerning facts of only peripheral relevance in deciding whether to hire or otherwise transact with an individual. This argument seems to me decisive against any rule requiring full disclosure of adverse personal information--on the model of the securities laws or the Truth-in-Lending Act. But it does not argue for granting legal protection to private facts about a person. And it is unlikely that the failure to create such rights just leads people to expend real resources on maintaining the secrecy of facts about themselves. No doubt such expenditures would be lower if there were such legal protection--but the same argument could be made on behalf of a proposal to give sellers a legally protected right to conceal adverse information about their product, and it is as unconvincing in the personal as it would be in the commercial context.

The arguments for privacy that I have reviewed are not absurd arguments. But as just suggested the same arguments could be made with equal force by a

seller asking for the right to conceal defects in his product, yet would be accorded scant consideration in that context. The basic point I wish to assert is the symmetry between "selling" oneself and selling a product. If fraud is bad in the latter context (see Darby and Karni)--at least to the extent that we would not think it efficient to allow sellers to invoke the law's assistance in concealing defects in their goods--it is bad in the former context, and for the same reasons: it reduces the amount of information in the market, and hence the efficiency with which the market--whether the market for labor, or spouses, or friends--allocates resources.

My argument to this point will have seemed normative, but that is not its purpose. Once privacy is seen to reduce the efficiency of the marketplace, we are in a position to predict the effect of the recent wave of statutes, federal and state, protecting privacy, as by placing arrest records beyond a prospective employer's reach and credit histories beyond a prospective creditor's reach (see Posner 1979e, pp. 41-50). If the analysis in this paper is correct, such statutes reduce wages and employment and increase interest rates.

The analysis in this paper is also suggestive with regard to the possible sources of privacy legislation. The principal beneficiaries of such legislation are people with more arrests or convictions, or poorer credit records (more judgments, bankruptcies, etc.), than the average person. These groups are presumably not cohesive enough to overcome the free-rider problems that plague efforts to form effective political coalitions, but they overlap strongly with racial and ethnic groups, namely black and Hispanic-Americans, which are politically organized. Given laws that forbid discrimination against members of these racial and ethnic groups, it may be in their interest to press for passage of laws that also forbid "discrimination" against people with poor credit records and lengthy criminal records. If employers and

creditors are unable to use these criteria to sift out poor employment risks and poor credit risks, respectively, a redistribution of wealth from whites to members of these racial and ethnic groups may result.

Table 1 (drawn from Posner 1981, ch. 10) presents some results broadly consistent with this theory. The dependent variable in the regressions reported there takes a value of 0 if the state has no privacy statute related to arrest, creditor or employment history, 1 if it has a statute in one of the categories, 2 if in two, etc. The key independent variable, MINO, measures the percentage black or Hispanic in the state. I add a variable which measures the amount of recent migration into the state (MIG) as a proxy for the social cost of privacy legislation, since the more often people change their residence the more difficult it is to obtain information about them that is useful in deciding whether to transact with them. Accordingly, the sign of MIG is expected to be negative. I also include a variable measuring per capita income in the state (INC) as a way of testing Stigler's compassion theory of privacy legislation. Finally, since a state's resistance to redistributive legislation (as I regard privacy legislation) may be a (presumably negative) function of the amount of redistribution it already engages in, I include several variables that measure the state's other redistributive activities, such as per capita tax burden (TAX) and progressivity of the state income tax (PROG).

MINO is positive and significant in all of the regressions. INC is positive in all of the regressions too, as predicted by the compassion theory, but significant in only two. MIG has the right sign (negative), but is never significant. The variables measuring the amount of redistributive activity in the state are mostly insignificant and in one case have the wrong sign.

If I am correct that privacy legislation is redistributive and reduces

TABLE 1

STATE PRIVACY STATUTE REGRESSIONS

(dependent variable = no. of relevant categories
in which state has enacted privacy statute)

	CONSTANT	TAX	PROG	RATIO1	RATIO2	TRAN	LTRAN	INC	LINC	MINO	MIG	R^2
1.	-1.013	-.0002						.0003		.0240	-.019	.12
	(-.940)	(-.178)						(1.323)		(2.073)	(-.864)	
2.	-1.428	-.0007	.030					.0004		.026	-.015	.14
	(-1.214)	(-.594)	(.889)					(1.550)		(2.210)	(-.627)	
3.	.060		.043	-8.292				.0003		.026	-.003	.18
	(.051)		(1.322)	(-1.554)				(1.854)		(2.199)	(-.105)	
4.	-1.033		.020		.327			.0003		.026	-.020	.13
	(-1.010)		(.567)		(.034)			(1.601)		(2.201)	(-.913)	
5.	-4.731					.023		.0005		.025	-.015	.23
	(-2.677)					(2.491)		(2.992)		(2.284)	(-.717)	
6.	-44.414)						2.539		3.797	.026	-.005	.28
	(-3.626)						(2.936)		(3.477)	(2.450)	(-.236)	

Source: Richard A. Posner, The Economics of Justice, ch. 10 (1981)(tab. 3)

[continued]

(Table 1 continued)

Notes: 1. t-statistics in parentheses

2. Definitions of independent variables:

TAX = state taxes per capita, 1976

PROG = maximum state income tax rate minus minimum state income tax rate

RATIO1 = ratio of per capita state and local expenditures excluding highway expenditures to state per capita income

RATIO2 = TAX/INC

TRAN = ratio of total transfer payments to INC, 1976

LTRAN = natural logarithm of TRAN

INC = state per capita income, 1976

LINC = natural logarithm of INC

MINO = percentage black and Hispanic-Americans in state

MIG = percentage of new residents since 1965

3. For data sources and other regressions see Posner, supra.

rather than increases efficiency, it may seem puzzling, in light of recent economic literature claiming that the common law is efficient (see, e.g., Posner 1977, pt. II), that the common law of torts recognizes and protects a "right to privacy." But on examination this right of privacy turns out to be consistent with the economic analysis in this paper (see Posner 1978, pp. 409-21). The tort right of privacy has four aspects. First, it prevents the use of a person's name or picture in advertising without his consent. The effect is to give a person a property right in his name and picture for purposes of advertising only (one cannot prevent a newspaper from publishing an unflattering picture of oneself in its news sections), and this maximizes the value of the name and picture in advertising without facilitating the use of the name or picture to mislead others.

Second, the tort law gives a person the right to prevent facts about him from being portrayed in a "false light." This right increases the amount of information in the marketplace. Third, the tort law prevents the obtaining of personal information by intrusive means, as by interfering with one's movements (an invasion of privacy in the second, and uncontroversial sense, discussed at the outset of this paper), or by eavesdropping. The economic objection to eavesdropping is that its principal effect is not to obtain information--not in the long run at least--but to reduce the effectiveness of communications. Knowing that people are overhearing my conversations, I will speak less frankly. The costs of communicating will be higher. Anyone familiar with the practical consequences of allowing student observers in faculty meetings will confirm the truth of this observation.

The only problematic aspect of the tort right of privacy is the right to prevent the publicizing of certain intimate facts about oneself. At first glance this right seems to be inconsistent with the economic analysis in this

paper. Why would someone want to conceal a fact, except to mislead others in transacting with him? Examination of the cases shows, however, that the right is upheld in very few cases. Only in California do the courts allow a criminal record to be suppressed in a suit by the ex-criminal against the media. Elsewhere suppression is allowed only where the facts publicized have no possible value to potential transacting partners of the individual bringing the suit. Admittedly, why people should want to suppress such facts is mysterious from an economic standpoint.

To summarize, given the rash of recent privacy legislation and the high level of public as well as scholarly concern with privacy, the extension of the economic study of information to the privacy of information seems overdue. This paper and the work it reports on are far from definitive. But they suggest that here as in other areas of nonmarket behavior the economist has a distinctive and valuable contribution to make to social science scholarship.

REFERENCES

Gary S. Becker, The Economics of Discrimination, 2d. ed., Chicago and London, 1971.

Michael R. Darby and Edi Karni, "Free Competition and the Optimal Amount of Fraud," J. Law & Econ., April 1973, 16, 67-88.

Frank H. Easterbrook, "FOIA and the Value of Private Information," J. Legal Stud., forthcoming November 1980, 9.

Jack Hirshleifer, "Privacy: Its Origin, Function, and Future," J. Legal Stud., forthcoming November 1980, 9.

Edmund Phelps, "The Statistical Theory of Racism and Sexism," Am. Econ. Rev., 1972, 62, 659ff.

Richard A. Posner, Economic Analysis of Law, 2d ed., Chicago & Toronto 1977.

_____, "The Right of Privacy," Ga. L. Rev., Spring 1978, 12, 393-422.

_____, "Privacy, Secrecy, and Reputation," Buffalo L. Rev., 1979, 28, 1-55.

_____, "The Uncertain Protection of Privacy by the Supreme Court," Sup. Ct. Rev., 1979, 173-216.

_____, The Economics of Justice, Cambridge, Mass. forthcoming 1981.

Steven Shavell,

J. Legal Stud., forthcoming November 1980, 9.

George J. Stigler, "An Introduction to Privacy in Economics and Politics," J. Legal Stud., forthcoming 1980, 9.