The economic approach to law, or “law and economics,” is by far the most successful application of basic economic principles to another scholarly field, but most of the critical appraisal of the field has been scattered among law reviews and economics journals. Theoretical Foundations of Law and Economics is the first original, book-length examination of the methodology and philosophy of law and economics, featuring new essays written by leading legal scholars, philosophers, and economists. The contributors take issue with many of the key tenets of the economic approach to law, such as its assumption of rational behavior, its reliance on market analogies, and its adoption of efficiency as the primary goal of legal decision making. They discuss the relevance of economics to the law in general, as well as to substantive areas of the law, such as contracts, torts, and crime.

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Theoretical Foundations of Law and Economics

Edited by
Mark D. White
College of Staten Island/City University of New York
To the memory of Anne White, beloved grandmother and friend.
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Foreword

RICHARD A. EPSTEIN

THE TWO SIDES OF SOCIAL SCIENTISTS

Social scientists of all stripes – and for these purposes I award lawyers their hard-earned stripes – face a peculiar personal challenge. How do they reconcile the way they think with the way they live? On the one hand, everyday observation suggests that in the course of a given day, people from all walks of life, social scientists included, make thousands of decisions both large and small, and routinely seem to experience little anxiety before and no regret after the process. Indeed, a moment’s reflection indicates how hard it would be to live a happy and productive life if faced with constant torment over these nonstop routine matters. The results of these commonplace actions are, of course, not uniform. For small repetitive events, most people do pretty well, most of the time.

The basic picture is not always so cheery. When the choices become larger and the need for fresh and full information more insistent, two things happen. Most ordinary people will reflexively invest more to get information before making decisions, only to discover in retrospect that the decisions they make frequently turn out less well than they had hoped. But these reversals, as the expression goes, “have to be taken in stride,” because there is no decision protocol or magic potion that relieves people from the burdens of risk and uncertainty, either on an individual or on the collective level. People try to learn from their mistakes, and they sometimes do. But often they make other mistakes in the future precisely because they spend too much time fighting the last war. And too much caution can lead to paralysis. The best anyone can do is to minimize the severity of any erroneous decision conditional on the level of uncertainty and decision-making costs. No one, acting in either a private or a public capacity, is able to eliminate decision errors, and no one should devote excessive energy to what can turn out to be a futile or even counterproductive quest.

And yet ordinary people must be doing something right “to last two hundred years,” as was said in Robert Altman’s Nashville. Look back even one hundred years, and things are unambiguously better today than they were then, both in the level of resources at our disposal and in the moral attitudes (at least in most western-style democracies). Whatever mishaps take place in decision making at the individual and collective levels cannot negate the powerful, if simple-minded,
Foreword

conclusion that in the grand scheme of things the negative consequences of wrong decisions are outweighed by the positive consequences of correct ones. The former decisions may receive most of the attention, as failures typically do, but that large base of success builds the material and moral capital that allows progress to take place. There is, as it were, in academic work a kind of selection bias that lays much stress on the failures and far less on the successes.

By and large social scientists – lawyers still included – do not find themselves paralyzed by the full range of theoretical difficulties that beset decision making by rational (a loaded word) agents. But notwithstanding their comparative success (as judged by income and achievement), they are drawn as moths to flames to examine the obstacles that block the path of sound decisions in all walks of life. And this set of essays is directed to various ways of addressing the major theoretical and practical problems that have to be faced in dealing with decision making. The stakes in the issues addressed in this work are enormous.

We can make with confidence two general statements about our public, business, and personal institutions. The first is wonderment at how they manage to function at all. The second is the evident truth that in spite of their disabilities they do manage to function. We can think of society as a piston engine, which produces a lot of energy, most of which is dissipated in heat, with just enough useful output to propel the vehicle forward. On this model, social output can double by increasing the efficiency of the engine from 20 to 40 percent, even though in both states of the world we waste more than we use. Knowing this, our collective ability to point out systemic errors may look to generate only smallish gains. But if we can wring, collectively and individually, another 5-percentage-point improvement that takes us from, say, 20 to 25 percent, then we can increase social output by 25 percent. The further we move up the cycle, the smaller the percentage increase from any new increment of gain.

For the foreseeable future, this form of invisible social leverage may promise major gains. But, as in all systems, leverage works in both directions. Let the wrong set of procedures be adopted, and a 5-percentage-point loss in overall output could reduce the efficiency of our social piston engine from 20 to 15 percent, for a perceived 25-percent loss in efficiency. The stakes then are enormous.

THE PROGRAM OF THIS BOOK: SOCIAL DECISION FROM THEORY TO PRACTICE

In one way or another each of these chapters seeks to address some of the fundamental questions that stand in the path of sound decisions. Many of the chapters in this volume start with the most fundamental of questions: what social criterion or criteria should be used to judge the success or failure of any decision? The choice of the singular “criterion” versus the plural “criteria” opens up a can of worms, which is thoughtfully addressed by William A. Edmundson in his chapter, “Pluralism, Intransitivity, Incoherence,” which grapples with this dilemma. A monist criterion gives a unique metric for making a decision, but it excludes the richness and diversity that plural criteria can supply at the cost, of course, of some incoherence. Which are we to choose? We are left to ponder.
Asking this question leads to others, such as to what extent within a plural world we rely on slimmed-down conceptions of utility to resolve all questions within an economic framework, as has been powerfully argued by Louis Kaplow and Steven Shavell in their controversial book, *Fairness versus Welfare* (2002). In this volume, this question is tackled in at least two different ways. The first asks whether there is sufficient internal coherence in the economic tests themselves. In his chapter, “Bounded Rationality and Legal Scholarship,” Matthew D. Adler examines the difficulties in figuring out within this tradition the correct form of rational decision making by individuals who have rational expectations but not the capability to implement confidently the kind of welfarist criterion proposed by Kaplow and Shavell.

Sometimes the theoretical attacks on welfarist models cut deeper. David Ellerman’s “Numeraire Illusion: The Final Demise of the Kaldor–Hicks Principle” takes the strong position that the measurement errors within standard economics render largely unintelligible the Kaldor–Hicks principle, which holds, of course, that a change in social rules counts as a social improvement if the winner under the changes can fully compensate the losers and still be left better off in the bargain.

In addition to those examinations of decision-making theory that operate within the economic tradition, other critiques seek to limit what might be termed their imperial ambitions. Mark Tunick, in his chapter “Efficiency, Practices, and the Moral Point of View: Limits of Economic Interpretations of Law,” raises some general objections to the constraints that a given notion of fairness should properly place on any efficiency notion of social welfare. Writing in a similar vein, Sarah Holtman, in her chapter “Justice, Mercy, and Efficiency,” asks the further questions of how institutions of mercy and forgiveness can exist side by side with justice and how this combination bears on the efficient operation of our other social institutions. The relationship between the normative and positive accounts is further explored by Horacio Spector in his chapter “Legal Fictionalism and the Economics of Normativity,” which pushes hard on the distinction between simple coercion by a powerful force and legitimate coercion used within the framework of a sound set of political institutions. In their chapter, “Functional Law and Economics,” Jonathan Klick and Francesco Parisi further pursue the effort to integrate the normative with the positive from a public choice perspective that examines how legislation, adjudication, and private markets can promote sound institutional structures that facilitate individual decision making. Lewis A. Kornhauser picks up a similar theme in his chapter on “Modeling Courts,” by asking what count as sound models of judicial behavior, taking into account the complex interplay between large policy judgments on the one hand and particular case decisions on the other.

The question of understanding the complexities of decision making must also be addressed in a somewhat narrower context that looks at the operation of legal rules and legal analysis in particular contexts. Michael B. Dorff and Kimberly Kessler Ferzan take a broad look at several areas of law—baby-selling, racial discrimination, and insider trading—whose thesis is well summarized in their title: “Is There a Method to the Madness? Why Creative and Counterintuitive Proposals Are Counterproductive.” Peter H. Huang tackles the perceptions of economic analysis on the part of noneconomic lawyers and laypersons, based on visceral affect and

The influence of cost–benefit arguments also weaves its way through the other chapters in this volume that concentrate on particular areas of substantive law. Guido Pincione, in his chapter “Welfare, Autonomy, and Contractual Freedom,” strikes a strong libertarian chord in stressing the intimate connection among these three venerable conceptions. Brian H. Bix writes on a similar theme in “Law and Economics and Explanation in Contract Law,” about the extent to which the approach that law and economics brings to ordinary conceptions of contractual justice can be squared with economic conceptions of efficiency. Mark A. Geistfeld also examines, in his chapter, “Efficiency, Fairness, and the Economic Analysis of Tort Law,” the possibility of a strong reconciliation of traditional norms of fairness with the economic analysis of law. Finally, Mark D. White, the energetic organizer of this volume, poses a strong challenge to the criminal-law theories of deterrence and retribution in a world of limited resources by asking in his chapter, “Retributivism in a World of Scarcity,” the simple but disarming question: is there only a right, or also a duty, of the state to punish those who have broken the law?

ONE PERSON'S BRIEF WORLDVIEW

Faced with these detailed expositions, it would be presumptuous of me in a short introduction to give my views on the many methodological and practical issues considered in such detail in this volume. But I cannot altogether resist the temptation to say a few words on behalf of my own views. The entire topic of cost–benefit analysis is driven by a sense of fatalism: however much we criticize various forms of cost–benefit analysis, we cannot live without such determinations. There is a real question how these calculations are to be made, but absent any real presentation of a comprehensive worldview that does without them, it seems best to figure out how these are best done, rather than to abandon their use in favor of political caprice or arbitrary power.

How then might this task be discharged? In this regard, it is critical to distinguish between two types of inquiries. The first is that which is appropriate in a state-of-nature setting, which seeks to set out some view of individual rights and duties in some hypothetical original condition. The second asks how to do cost–benefit analysis in the here and now.

On the initial question, it is necessary to paint with a very broad brush in order to design human institutions to take into account one imperative from which no one can escape: the power of individual (and familial) self-interest in a world of scarcity. I have little doubt that in working on this large canvas there is much to be said for making the judgments that have long animated the defenders of limited government (Locke, Hume, Smith, Madison, Mill, Hayek, and Friedman, to name a few) that see these essential elements in the overall system. A strong sense of individual autonomy that resists the collective ownership of individual talents and abilities; the creation of easy rules that allow for the creation of private ownership in otherwise unowned land and objects, which is usually done through a system of first possession; the protection of these entitlements against force and fraud,
but not against competition; and a recognition of the limitations inherent in this
system because of several consistent problems of market failure – the premature
exhaustion of common goods resources, the need to create social infrastructure
funded by tax revenues, and some legal rules to address monopolization and
cartelization. The risks of excessive government power, however, argue for the
creation of separate powers that are able to check the operation of each other. The
exact details of these systems are beyond the scope of this foreword, but their simple
enumeration explains why such fields as property, contract, tort, and restitution
dominate the private law, and matters of government structure and the protection
of individual rights dominate our constitutional thinking. The goal here is to pick
a few tasks to be done well, and to avoid more ambitious schemes that end in
failure. A global cost–benefit analysis shows how each of these departures from a
state of nature is likely to improve human welfare.

There is, of course, a profound sense in which these large questions have already
been put to rest one way or the other, so that cost–benefit analysis in the modern
setting has to do with the design of public highway systems that must address
at the micro level such mundane questions as where roads should be located
and how traffic should be governed by line markers, traffic lights, and stop signs.
Similarly, countless judgments have to be made as to what drugs or chemicals
should be allowed on the market, with what kinds of warnings, and subject to
what kinds of liability. These questions are manifestly not amenable to the big-
think approach that dominates state-of-nature theory. But for them two kinds of
general guideposts seem appropriate. The first of these is to try to privatize as many
of the cost–benefit decisions as possible. A tort law (like a sporting contest) that
judges individuals by the outcomes of their behavior will do better than one that
seeks to make a collective, and retrospective, cost–benefit analysis of their choice.
That is why we ask only whether the ball was hit fair or foul, ignoring all questions
of inputs. And in those cases where collective choices have to be made, as with
the location of an airport, the proper approach is to ask individuals to compare
alternative proposals at the margin, in the effort to see what kinds of trade-offs are
likely to produce positive or negative social effects. The more focused the inquiry,
the better the outcome is likely to be. In general, a sensible system of collective cost–
benefit analyses should steer us away from ambitious and utopian objectives, most
of which will fail. Regimes of positive rights (good against the state and funded
by tax revenues) are likely to come up short whether we deal with agriculture,
housing, or health care. Our collective tools are limited, and so too should be our
collective ambitions. After reading these chapters, the reader has to decide whether
this brief philosophical outlook is welcome realism – or unwarranted pessimism.
Preface

MARK D. WHITE

It has long been my opinion that advocates of the economic approach to law – with the notable exception of Richard Posner – have been almost entirely unreflective on the methodological foundations of their field and the philosophical commitments implied thereby. (To be fair, this is true of most economists overall, but I think they ought to be especially careful when playing in someone else’s sandbox.) This shortcoming was all too well evidenced by the critical drumming taken by Louis Kaplow and Steven Shavell’s 2002 book, *Fairness versus Welfare*, which was the subject of dozens of published essays by legal scholars, including almost all of the contributors to this book, many of whom address it in their chapters as well. While law-and-economics scholars continue to employ the same tools, rusty and outdated though some of them may be – the tools, not the scholars! – it seems to fall to legal, moral, and political philosophers (and a few vagabond economists) to recommend improvements, refinements, and occasionally abandonment of the toolbox. The chapters in this volume offer a contribution to this effort, and if they inspire others to take up the cause, so much the better.

I would like to express my appreciation for the support and encouragement of John Berger and Cambridge University Press, who helped immeasurably in making this collection a reality. I also want to thank Roger Backhouse (International Network for Economic Methodology) and Mary Lesser (Eastern Economic Association), who graciously hosted conference sessions in which several of the contributors presented their work. Finally, my most heartfelt gratitude is owed to all of the fine scholars involved in this book, who made my job as editor a most rewarding and painless one.
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