Introduction

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How does law actually affect people? What do people do in response to the law? Why is the law as it is? How can law be enlisted to improve people’s lives? This book attempts to provide some answers. It is also the first general effort to bring behavioral economics to bear on the analysis of law.

In the last two decades, social scientists have learned a great deal about how people actually make decisions. Much of this work requires qualifications of rational choice models, which have dominated the social sciences, including the economic analysis of law. Those models are often wrong in the simple sense that they yield inaccurate predictions. People are not always “rational” in the sense that economists suppose. But it does not follow that people’s behavior is unpredictable, systematically irrational, random, rule-free, or elusive to social scientists. On the contrary, the qualifications can be described, used, and sometimes even modeled.

The purpose of this book is to bring new and more accurate understandings of behavior and choice to bear on law. The purpose of this introduction is to say something about the field and about the book’s structure and content.

Constructed Preferences

Human preferences and values are constructed rather than elicited by social situations.1 People do not walk around with menus in their heads: “[O]bserve[d] preferences are not simply read off some master list; they are actually constructed during the elicitation process…” Different elicitation procedures highlight different aspects of options and suggest alternative heuristics, which give rise to inconsistent responses.”2 Human beings do not generally consult a freestanding “preference menu” from which selections are made at the moment of choice; preferences can be a product of procedure, description, and context at the time of choice: “Alternative descriptions of the same choice problems lead to systematically different preferences; strategically equivalent elicitation procedures give rise to different choices; and the
preference between x and y often depends on the choice set within which they are embedded."

Analysis of law should be linked with what we have been learning about human behavior and choice. After all, the legal system is pervasively in the business of constructing procedures, descriptions, and contexts for choice. Most obviously, the legal system creates procedures, descriptions, and contexts in the course of litigated cases. For example, the alternatives (selected to be) placed before a jury or judge may matter a great deal; liability or conviction on some count A may very much depend on the nature of counts B, C, and D (as suggested by Chapter 2). In this respect the preferences and values of judges and juries can be constructed, not elicited, by the legal system.

Certainly this is true for the award of damages, where special problems may arise. But similar points hold outside of the courtroom. The legal system's original allocation of entitlements, and the structures created for exchange (or nonexchange) by law, may well affect people's preferences and values (as suggested by a number of papers in Part II). Thus law can construct rather than elicit preferences internally, by affecting what goes on in court, and externally, by affecting what happens in ordinary transactions, market and nonmarket.

We might distinguish among three different tasks of those interested in law: positive, prescriptive, and normative. Positive work is concerned with predictions. What will be the effects of law? Why does law take the form it does? If, contrary to conventional assumptions, people dislike losses far more than they like equivalent gains, predictions will go wrong insofar as they rest on conventional economic assumptions. As we will see, this point has important implications for positive analysis of law, prominently including the Coase Theorem, for which Ronald Coase received the Nobel Prize; indeed, behavioral law and economics shows that the Coase Theorem is often wrong (See chapters 8 and 10).

Prescriptive work is concerned with showing how society might actually reach our shared goals. If we want to decrease poverty, or save more lives, or decrease pollution, how can we do it? Consider the following information campaigns, which conventional analysis deems equivalent. (1) If you use energy conservation methods, you will save $X per year. (2) If you do not use energy conservation methods, you will lose $X per year. It turns out that information campaign (2) is far more effective than information campaign (1). As we will see, important features of human judgment, properly understood, undermine conventional thinking about what will work best; they help explain, to take just one example, precisely why the public service advertising slogan "Drive defensively; watch out for the other guy" is particularly ingenious.

Normative work is of course concerned with what the legal system should do. Recent revisions in understanding human behavior greatly unsettle certain arguments against paternalism in law. They certainly do not make an
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affirmative case for paternalism, but they support a form of anti-anti-paternalism. If, for example, people use heuristic devices that lead to systematic errors, their judgments about how to deal with risks may be badly misconceived. If people are unrealistically optimistic, they may run risks because of a factually false belief in their own relative immunity from harm, even if they are fully aware of the statistical facts. And if people’s choices are based on incorrect judgments about their experience after choice, there is reason to question whether respect for choices, rooted in those incorrect judgments, is a good way to promote utility or welfare. None of these points make a firm case for legal paternalism, not least because bureaucrats may be subject to the same cognitive and motivational distortions as everyone else. But they suggest that objections to paternalism should be empirical and pragmatic, having to do with the possibility of education and likely failures of government response, rather than being a priori in nature.

Heuristics and Biases

The first part of the book is concerned with heuristics and biases. It is now well established that people make decisions on the basis of heuristic devices, or rules of thumb, that may work well in many cases but that also lead to systematic errors. It is also well established that people suffer from various biases and aversions that can lead to inaccurate perceptions. Here is a very brief description of several biases and heuristics of particular relevance to law.

Biases

Extremeness Aversion. People are averse to extremes. Whether an option is extreme depends on the stated alternatives (See Chapter 2). Extremeness aversion gives rise to compromise effects. As between given alternatives, most people seek a compromise. Almost everyone has had the experience of switching to, say, the second most expensive item on some menu of options, and of doing so partly because of the presence of the most expensive item. In this as in other respects, the framing of choice matters; the introduction of (unchosen, apparently irrelevant) alternatives into the frame can alter the outcome. When, for example, people are choosing between some small radio A and a midsized radio B, most may well choose A; but the introduction of a third, large radio C is likely to lead many people to choose B instead. Thus the introduction of a third, unchosen (and in that sense irrelevant) option may produce a switch in choice as between two options.

Extremeness aversion suggests that a simple axiom of conventional economic theory – involving the irrelevance of added, unchosen alternatives –
is wrong. It also has large consequences for legal advocacy and judgment, as well as for predictions about the effects of law. How can a preferred option best be framed as the “compromise” choice? When should a lawyer argue in the alternative, and what kinds of alternative arguments are most effective? This should be a central question for advocates to answer. Juries and judges may well try to choose a compromise solution, and what “codes” as the compromise solution depends on what alternatives are made available. And in elections, medical interventions, and policy making, compromise effects may matter a great deal.

**Hindsight Bias.** According to a familiar cliche, hindsight has 20-20 vision. The cliche turns out to hold an important truth, one with considerable relevance to law. A great deal of evidence suggests that people often think, in hindsight, that things that happened were inevitable, or nearly so. The resulting “hindsight bias” can much distort legal judgment if, for example, juries end up thinking that an accident that occurred would inevitably have occurred. Judgments about whether someone was negligent may well be affected by this bias. Chapter 3 discusses hindsight bias in detail.

**Optimistic Bias.** Human beings tend to be optimistic. By itself this seems to be good news; but it can lead them to make big mistakes. Even factually informed people tend to think that risks are less likely to materialize for themselves than for others. Thus there is systematic overconfidence in risk judgments, as the vast majority of people believe that they are less likely than other people to be subject to automobile accidents, infection from AIDS, heart attacks, asthma, and many other health risks. Reflecting illusions about their own practices, gay men appear systematically to underestimate the chance that they will get AIDS, even though they do not lack information about AIDS risks in general. As Chapter 1 suggests, unrealistic optimism creates a distinctive problem for conventional objections to paternalism in law. If people tend to believe that they are relatively free from risks, they may lack accurate information even if they know statistical facts. As Chapters 5 and 11 suggest, optimistic bias is relevant to a number of areas of law and has some surprising implications.

**Status Quo Bias.** People tend to like the status quo, and they demand a great deal to justify departures from it. More specifically, people evaluate situations largely in accordance with their relation to a certain reference point; gains and losses from the reference point are crucial. This is a central finding of prospect theory. In law, an ordinary reference is the status quo, which produces status quo bias, an important phenomenon for the law; Chapter 4 discusses the relationship between contract law and status quo bias.
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Heuristics

Behavioral economists and cognitive psychologists have uncovered a wide array of heuristic devices that people use to simplify their tasks.

Availability. People tend to think that risks are more serious when an incident is readily called to mind or “available.” If pervasive, the availability heuristic will produce systematic errors. Assessments of risk will be pervasively biased, in the sense that people will think that some risks (of a nuclear accident, for example) are high, whereas others (of a stroke, for example) are relatively low. The availability heuristic appears to affect the demand for law (see Chapters 1, 13, and 15).

Anchoring. Often people make probability judgments on the basis of an initial value, or “anchor,” for which they make insufficient adjustments. The initial value may have an arbitrary or irrational source. When this is so, the probability assessment may go badly wrong. Jury judgments about damage awards, for example, are likely to be based on an anchor; this can produce a high level of arbitrariness.

Case-based Decisions. Because it is often difficult to calculate the expected costs and benefits of alternatives, people often simplify their burdens by reasoning from past cases, and by taking small, reversible steps. This form of “case-based decision” plays an important role in courts, which tend to think analogically (see Chapter 7).

The various biases and heuristics raise a large question: Can individuals and institutions make metadecisions, or second-order decisions, that will make it more likely that things will go well? Chapter 7 discusses a number of possibilities.

Valuation

The second part of the book deals with valuation. How do people react to gains and to losses? The legal system frequently deals with dollars; can people think well about dollars? What are the characteristics of their thinking?

Loss Aversion. People are especially averse to losses. They are more displeased with losses than they are pleased with equivalent gains — roughly speaking, twice as displeased. Contrary to economic theory, people do not treat out-of-pocket costs and opportunity costs as if they were equivalent.

Loss aversion has important implications for positive analysis of law. It means, for example, that the Coase Theorem is in one respect quite wrong. Recall that the Coase Theorem proposes that when transaction costs are zero, the allocation of the initial entitlement will not matter, in the sense that
it will not affect the ultimate state of the world, which will come from voluntary bargaining. The theorem is wrong because the allocation of the legal entitlement may well matter, for those who are initially allocated an entitlement are likely to value it more than will those without the legal entitlement. Thus workers allocated a (waivable) right to be discharged only for cause may well value that right far more than they would be if employers were allocated a (tradable) right to discharge at will. Thus breathers of air may well value their (tradable) right to be free from air pollution far more than they would if polluters had been given a (tradable) right to emit polluting substances into the air. The legal entitlement creates an endowment effect, that is, a greater valuation stemming from the mere fact of endowment. Chapters 8, 10, 12, and 13 relate this finding to a number of legal issues.

There is a further point. People are averse to losses, but whether an event “codes” as a loss or a gain depends not on simple facts but on a range of contextual factors, including how the event is framed. The status quo is usually the reference point, so that losses are understood as such by reference to existing distributions and practices; but it is possible to manipulate the frame so as to make a change code as a loss rather than a gain, or vice versa. Consider a company that says “cash discount” rather than “credit card surcharge,” or a parent who says that for behavior X (rather than behavior Y) a child will be rewarded as opposed to saying that for behavior Y (rather than for behavior X) a child will be punished, or familiar advertisements to the effect that “you cannot afford not to” use a certain product. In environmental regulation, it is possible to manipulate the reference point by insisting that policy makers are trying to “restore” water or air quality to its state at time X; the restoration time matters a great deal to people’s choices.9

For present purposes, the most important source of reference points is the law – where has the legal system placed the initial entitlement? Much of Part II discusses the effects of this initial allocation.

Loss aversion also raises serious questions about the goal of the tort system. Should damages measure the amount that would restore an injured party to the status quo ante, or should they reflect the amount that an injured party would demand to be subject to the injury before the fact? Juries appear to believe that the amount that would be demanded pre-injury is far greater than the amount that would restore the status quo ante. The legal system appears generally to see the compensation question as the latter one, though it does not seem to have made this choice in any systematic way. Chapter 10 treats this issue in detail.

Mental Accounting. A simple and apparently uncontroversial assumption of most economists is that money is fungible. But the assumption is false. Money comes in compartments. People create “frames” that result in mental accounts through which losses and gains, including losses and gains in simple monetary terms, are not fungible with each other. A glance at ordinary
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practice shows that people often organize decisions in terms of separate budgets and accounts. Thus some money is for retirement; some is for vacation; some is for college tuition; some is for mortgage or rental payments. Mental accounting is an important aspect of financial self-control, and the practice of mental accounting has a range of implications for law and policy. It suggests, for example, that government may be able to create certain mental accounts by creative policy making. It also suggests that there may be a demand for publicly created mental accounts, perhaps as a self-control strategy, as, for example, with Social Security and other programs with an apparent paternalistic dimension. Some statutes that appear to prevent people from making choices as they wish may be best understood as responsive to the widespread desire to have separate mental accounts. Of course, there are private mechanisms for accomplishing this goal, but lawyers will not understand those mechanisms well unless they see that money itself is not fungible. Chapter 11 deals with mental accounting in the context of legal rules.

The Difficulty, Outside of Markets, of Mapping Normative Judgments Onto Dollars. Often the legal system requires judges or juries to make judgments of some kind and then to translate those judgments into dollar amounts. How does this translation take place? Can it be done well? Chapter 9 suggests that in many contexts, normative judgments of a sort are both predictable and nonarbitrary. With respect to bad behavior that might produce punitive damages, for example, people come up with relatively uniform judgments on a bounded numerical scale. Similar findings have been made for environmental amenities in the context of contingent valuation. But the act of mapping those normative judgments onto an unbounded dollar scale produces considerable “noise” and arbitrariness. When people are asked how much they are willing to pay to protect two thousand birds, or how much a defendant should be punished for reckless conduct leading to personal injury, the numbers they generate seem to be stabs in the dark.

The legal system, however, frequently relies on just those stabs. Thus the award of damages for libel, sexual harassment, and pain and suffering is affected by severe difficulties, as is the award of punitive damages in general. An understanding of those difficulties may well lead to concrete reform proposals. Perhaps the “mapping” can occur by a legislative or regulatory body that decides, in advance, on how a normative judgment made by a bounded numerical scale can be translated into dollars.

The Demand for Law

The third part of the book deals with the demand for law. Why is law as it is? Behavioral law and economics provides some distinctive answers.
**Self-serving bias.** People’s judgments about fairness are self-serving, and they tend to be both unrealistically optimistic and overconfident about their judgments. In any random couple, it is highly likely that addition of answers to the question “What percentage of the domestic work do you do?” will produce a number greater than 100 percent. The point bears on the otherwise largely inexplicable phenomenon of bargaining impasses (see Chapter 14). Why don’t more cases settle? Why does the legal system spend so much on dispute settlement? Part of the answer lies in the fact that self-serving bias—a belief that one deserves more than other people tend to think—affects both parties to a negotiation, and this makes agreement very difficult.

**Cooperation, Fairness, Spite, and Homo Reciprocans.** Economists sometimes assume that people are self-interested, in the sense that they are focused on their own welfare rather than that of others, and in the sense that material welfare is what most concerns them. This is sometimes true, and often it is a useful simplifying assumption. But people also may want to be treated fairly and to act fairly, and, perhaps even more important, they want to be seen to act fairly, especially but not only among nonstrangers. For purposes of understanding law, what is especially important is that people may sacrifice their economic self-interest in order to be, or to appear, fair. Rather than being *homo economicus*, people may be *homo reciprocans.*

Consider, for example, the ultimatum game (discussed in Chapter 1). The people who run the game give some money, on a provisional basis, to the first of two players. The first player is instructed to offer some part of the money to the second player. If the second player accepts that amount, he can keep what is offered, and the first player gets to keep the rest. But if the second player rejects the offer, neither player gets anything. Both players are informed that these are the rules. No bargaining is allowed. Using standard assumptions about rationality, self-interest, and choice, economists predict that the first player should offer a penny and the second player should accept. But this is not what happens. Offers usually average between 30 and 40 percent of the total. Offers of less than 20 percent are often rejected. Often there is a 50-50 division. These results cut across the level of the stakes and also across diverse cultures.

The results of the ultimatum game are highly suggestive. Perhaps people will not violate norms of fairness, even when doing so is in their economic self-interest, at least if the norm violations would be public. Do companies always raise prices when circumstances create short-term scarcity? For example, are there social constraints on price increases for snow shovels after a snowstorm, or for umbrellas during a rainstorm? It may well be that contracting parties are reluctant to take advantage of misfortune, partly because of social constraints on self-interested behavior. Here there is much room for future work. Experimental work shows a high degree of cooperation in Prisoner’s Dilemma situations, especially when people are speaking
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with one another. Chapter 12 shows that acrimony, or spite, can play an important role in determining legal outcomes.

Availability Again and Social Influences. We have seen that people make judgments about probability on the basis of judgments about available or easily retrievable instances. Moreover, the availability heuristic operates in an emphatically social environment. People often think and do what (they think) other people think and do. Partly this is because when a person lacks much personal information, he will sensibly rely on the information of others. If you don’t know whether pesticides cause cancer, or whether hazardous waste dumps are a serious social problem, you may as well follow what other people seem to think. And partly this is because of reputational influences. If most people think that hazardous waste dumps are a serious social problem, or that laws should ban hate crimes, you might go along with them, so that they do not think that you are ignorant, malevolent, or callous. These points have a wide range of implications for the content of law. They help explain the supply of, and the demand for, government regulation. “Availability cascades” help drive law and policy in both fortunate and unfortunate directions (see Chapter 15).

The Future

Behavioral law and economics is in its very early stages, and an enormous amount remains to be done. Some of the outstanding questions are foundational and involve the nature of economics itself: Can behavioral economics generate a unitary theory of behavior, or is it an unruly collection of effects? Is it too ad hoc and unruly to generate predictions in the legal context? As compared with approaches based on ordinary rationality assumptions, does behavioral economics neglect the value of parsimony? In what sense is behavioral economics a form of economics at all?

Many unanswered questions are empirical, and these remain to be studied in both real-world and experimental settings. An especially important issue has to do with the possibility of increasing cooperative behavior and decreasing spiteful behavior. What are the preconditions for the two? When does law produce one or the other? From another direction, it would be highly desirable to have a full data set of jury awards in cases involving injuries that are hard to monetize (libel, pain and suffering, sexual harassment, and intentional infliction of emotional distress), and to see what factors account for high or large awards. Whether normative judgments are widely shared, and dollar awards widely divergent (as found in Chapter 9), is an intriguing issue in numerous areas of the law.

A very large question involves the extent to which education can counteract cognitive and motivational distortions, so as to eliminate some of the
effects described above. (Some of these effects of course should not be con-
considered distortions; people who care about reciprocity can keep themselves 
out of a lot of trouble.) Is it possible for those involved in law to “debias” 
people, in the process, perhaps, lengthening human lives? What institutions 
work best at reducing the effects of biases? Would a broader understanding 
of behavioral economics produce learning, and thus make it less necessary 
to use behavioral economics?

Despite its length, this book is intended above all as a beginning – to new 
and improved understandings of the real-world effects of law, and ultimately 
to better uses of law as an instrument of social ordering.

Notes
1 See Paul Slovic, The Construction of Preference, 50 Am. Psychol. 364 (1995); Amos 
Tversky, Rational Theory and Constructive Choice, in The Rational Foundations 
Economic Behavior (Kenneth Arrow et al. eds., 1996).
2 Amos Tversky, Shmuel Sattath, and Paul Slovic, Contingent Weighting in Judgment 
3 Tversky, supra note 1, at 186.
6 Laurie Bauman and Karolyn Siegel, Misperception Among Gay Men of the Risk for 
7 See David Kahneman and Amos Tversky, Judgment Under Uncertainty: Heuristics 
and Biases in Judgment Under Uncertainty 3 (David Kahneman et al. eds., 1982).
8 See Itzhak Gilboa and David Schmeidler, Case-Based Decision Theory, 110 Q. J. Econ. 
9 See Robin Gregory, Sarah Lichtenstein, and D. MacGregor, The Role of Past States in 
Determining Reference Points for Policy Decisions, 55 Org. Behav. & Hum. Decision 
10 See Ernst Fehr and Simon Gachter, How Effective Are Trust- and Reciprocity-Based 
Incentives, in Economics, Values, and Organization 337 (Avner Ben-Ner and Louis 
Putterman eds., 1998).
11 See The Handbook of Experimental Economics 111–73 (John H. Kagel and Alvin E. Roth 
ed., 1995) for an overview. There is thus a close relation between some behavioral 
research and the growing and apparently independent interest in regulation via 
social norms. See also R. Ellickson, Order Without Law (1991). I believe that ultimately 
these two lines of inquiry will merge into a unitary field of inquiry.