

evaluative. The descriptive thesis holds that economic concepts and principles provide illuminating descriptions of legal rules. The explanatory thesis holds that economic concepts and principles help provide the best explanation for why society has the legal rules it has. And the evaluative thesis holds that economic concepts and principles provide sound criteria for evaluating legal rules and determining which ones society ought to have.

The descriptive and explanatory theses are made more specific by proponents of law and economics by focusing on particular areas of law and their economic efficiency. Accordingly, two of the principal claims of law and economics are (1) the rules of common law are economically efficient, and (2) the rules of common law are what they are because they are economically efficient.

These two claims about the efficiency of the common law are specifications of the descriptive and explanatory theses, respectively. It is clear that the explanatory claim presupposes the truth of the descriptive one: efficiency cannot explain the rules of common law unless we suppose that the common law can be accurately described as efficient in the first place.

What about the reverse relationship: Does the descriptive thesis presuppose the truth of the explanatory thesis? The answer is no, because the common law could be economically efficient even though its efficiency is not what explains it. In such a case, it would still be important to know that the common law was efficient. Showing that it was so would contribute to our understanding of the common law, even if we would need to look beyond efficiency for an explanation of why it contains the particular legal rules it does.

The evaluative thesis of law and economics is made more specific by the claim that economic efficiency provides a criterion for evaluating the law: other things being equal, inefficient legal rules should be replaced by efficient ones, and efficient ones should be maintained. These evaluative claims about efficiency stand or fall, regardless of whether the law as a whole (or some area of it) is explained by its economic efficiency or is even efficient in the first place. The idea that the law should be efficient must be defended or criticized apart from the other claims of the law and economics movement about what the law is and why it is.

ECONOMIC RATIONALITY

In this section, we will focus on the economic concept of rationality. It is one of two concepts at the center of how the economic approach describes, explains, and evaluates human actions and institutions. The other concept is that of efficiency, which we will examine in the next main section.

Rational Action

From the economic perspective, human action is essentially rational, and the rationality of an action is a function of its costs and benefits to the agent. Costs and benefits refer to the entire range of considerations that make something better or worse for an individual. Monetary considerations are included, but

Law and Economics



THE ECONOMIC ANALYSIS OF LAW

Positive law is made and maintained by the decisions and actions of human beings. In light of that fact, it is reasonable to think that fields of study focusing on human behavior and institutions can contribute to the understanding of the law. Accordingly, it is unsurprising to find that such fields as sociology, psychology, and anthropology have made important contributions to the study of law. Psychologists, for example, have studied how verdicts in criminal cases are affected by whether the prosecution or the defense goes last in giving its closing statement to the jury. And anthropologists have described and contrasted the distinct ways in which different cultures handle disputes that break out among their members. But in recent years, some thinkers have proposed that the principles of economics provide the best way to describe, explain, and evaluate the rules of any system of positive law. These thinkers have established the "law and economics movement."

The law and economics movement is part of a trend that uses economic ideas, such as the concept of efficiency, to account for decisions and practices seemingly far removed from the impersonal transactions of the marketplace. For example, economic analyses have been given of dating, courtship, and marriage. The underlying idea here is that the principles of economics do not apply merely to some narrowly restricted range of human behavior; they apply to human activities and practices across the board, including the law. We should be careful to distinguish among three separate theses belonging to the law and economics approach: the descriptive, the explanatory, and the

costs and benefits are not restricted to financial gains and losses. Suppose I receive an award for my work. Suppose that no money goes along with the award and that having it will not indirectly increase my income in any way (unlike, say, an Olympic gold medal). Still, the award would count as a benefit as long as it made me better off in some way, for example, by increasing my prestige among my colleagues or just by making me feel good.

According to the economic approach, each individual is the ultimate judge of what makes her better or worse off. In other words, each person's preferences determine what counts as a cost or benefit for her.¹ Moreover, the economic approach assumes that all costs and benefits can be mathematically represented in terms of some common unit of measurement. In practice, monetary units (for example, dollars) are used. Thus, gaining prestige among my colleagues is not itself monetary compensation, but its value to me can be represented in terms of dollars. Rational decisions reflect the net benefits of the decision. In other words, they reflect the gains minus the losses. For economic analysts, the crucial gains and losses are the marginal ones. Marginal costs and benefits are the ones added to (or subtracted from) what one already has. By focusing on marginal costs and benefits, one can determine when one has maximized one's net benefits.

An Example: The Rational Athlete

Consider an athlete whose training involves sit-ups in order to increase the strength of her abdominal muscles. Suppose that we ignore all of her other aims in life and focus only on her task of strengthening her abdominal muscles. If she has done fifteen sit-ups at a certain training session, doing an extra, sixteenth sit-up will bring an added benefit. But the extra benefit will be less than the extra benefit of doing the tenth sit-up after having already done nine of them. The marginal benefit of the sixteenth sit-up is still positive, but it is not as high as the marginal benefit of the tenth.

In general, the marginal benefits of a beneficial activity decrease as the activity continues. Similarly, the marginal benefits of a good thing decrease as one obtains more of the thing: the added benefit of a loaf of bread is less to you if you already have ten loaves than if you only have one.²

Benefits are maximized when one engages in a beneficial activity until the point at which its net marginal benefits drop to zero. After that point, further activity decreases one's overall benefits, while up to that point, further activity increases the benefits. Of course, even beneficial activities have costs that must be accounted for in determining their net marginal benefits, in particular, the opportunity cost of foregoing some other activity. Suppose that by doing sit-ups our athlete is foregoing another exercise, say, leg lifts, which provides the next best way of increasing the strength of her abdominal muscles. The cost of doing sit-ups is determined by how much benefit she forgoes by not doing the leg lifts. How many sit-ups would she do, assuming she is rational?

Suppose that the marginal benefit of the thirtieth sit-up is greater than that of the first leg lift, but the marginal benefit of the thirty-first sit-up is less than that of the first leg lift. She would maximize her net benefits by doing thirty sit-ups and then switching to leg lifts. How many leg lifts would she do? Assuming

she is rational, she would perform each additional leg lift until the marginal benefits decrease so as to become equal to the marginal costs. Past that point, she would be detracting from her net benefits instead of maximizing them. According to economic analysis, then, rational action maximizes one's net benefits, and maximizing one's net benefits entails acting to the point at which marginal benefits minus marginal costs becomes zero.

Rationality and Uncertainty

In most situations in life, it is not certain what the gains and losses will be from any given choice or action. Rational choice under such conditions of uncertainty is handled using the idea of expected benefits (or losses). The expected benefit of a choice is simply the benefit multiplied by the probability of its occurrence. If there is a 10 percent chance (0.10) of my receiving \$10, then my expected benefit is \$1. Economic analysts will concede that not all human conduct is rational in exactly the way they describe. But they will insist that their idea of rational action provides a very good approximation of much human conduct, applicable across the spectrum of human activities. Moreover, economic analysts will contend that their approach provides the most systematic and comprehensive approach to describing and explaining human conduct. It might be possible to come up with counterexamples, in which persons do not maximize their net (expected) benefits. But there is no alternative theory that does a better job than the economic approach. It may not be perfect, because humans are not always perfectly rational, but the economic approach is by far the best game in town.³ Or so the economic analysts of law argue.

ECONOMIC EFFICIENCY

The economic concept of efficiency concerns the costs and benefits of an action, rule, or institution to society as a whole rather than to a specific individual. The concept rests on the idea that society is simply the sum of the individuals who make it up. Accordingly, the costs and benefits to society as a whole is a function of the costs and benefits to each affected individual. But how are the costs and benefits to different individuals to be compared and weighed against one another?

Utilitarianism and Beyond

Economic thinkers developed their answer to this question by considering the problems with a utilitarian approach and formulating several alternatives to it. Let us examine the utilitarian approach and the problems it encounters. In its classic formulation, the utilitarian approach holds that the total good to society of some act or rule is determined by the net balance of pleasure over pain produced by the act or rule. The net balance is calculated by summing up the pleasure produced for each individual (taking into account its intensity, duration, and so on) and subtracting the pain produced for each individual (also taking account of its intensity, duration, and so on). If we used this

approach to define efficiency, we would say that an efficient act or rule is one that maximizes the net balance of pleasure over pain, summing up the pleasures and pain over all affected individuals.

The critical problem that economic thinkers see in this approach to defining efficiency is that it assumes one can compare the pleasures and pains of different persons and say how much more one person's pleasure (or pain) is than another's. The simple fact seems to be that there is no way to make such "interpersonal utility comparisons."

Jack may be able to say reliably that his pleasure in eating fried chicken outweighs his pain in having indigestion. Or that his pleasure in playing basketball is greater than his pleasure in playing cards. But how can anyone determine how much more (or less) Jack's pleasure in playing basketball is than Jill's pleasure in playing cards? It seems that there is no way to compare the subjective experiences of different individuals because that would demand the impossible task of getting inside their heads. Yet, if we want to know whether it is efficient for Jack and Jill to play basketball or to play cards, a utilitarian approach to efficiency demands that we make such comparisons between the pleasures of Jack and those of Jill.

Pareto's Concepts of Efficiency

Vilfredo Pareto, an economist, developed two concepts of efficiency that circumvented the problem of interpersonal utility comparisons. The two concepts are called "Pareto optimality" and "Pareto superiority." Both concepts enable one to measure the efficiency of different ways of allocating society's resources, and both can be applied without getting inside the minds of the affected persons and comparing their subjective experiences. Let us examine their meanings.

Suppose that all of society's resources are in a box, waiting to be allocated to its members. Suppose that X represents one specific allocation of those resources. X is Pareto-optimal if and only if there is no way to change that allocation to make at least one person better off without making anyone worse off. Conversely, X would fail to be Pareto-optimal if and only if there were some way to change the allocation so as to make at least one person better off without making anyone else worse off.

Pareto superiority involves a comparison between any two ways of allocating the same set of resources. Let X represent one way of allocating the resources and Y another. X is Pareto-superior to Y if and only if at least one person is better off with X than with Y and no one is worse off with X than with Y . And if some persons are better off with Y but others are worse off with X than Y , then we cannot say that either X or Y is Pareto-superior. X and Y are noncomparable. Both Pareto optimality and Pareto superiority dispense with interpersonal utility comparisons in the determination of efficiency. For they only require us to determine for each affected individual whether he or she would be better off, worse off, or the same under various, possible allocations. And according to the economic analysts who use these Pareto criteria, it is not necessary to get inside anyone's head in order to determine whether someone is made better off or not by some change in the allocation of resources. That is because a person's behavior

will show whether he is made better off or not. If a person would voluntarily pay (that is, give up some valuable resource of his) in order to move from what he has with allocation X to what he would have with Y , then that person is better off with Y than with X . And if the person would pay to avoid moving from what he has with X to what he would have with Y , then he is worse off with Y than with X . For example, suppose that Jack and Jill are the only two people involved, that X consists of Jack having a cow and Jill having a horse, and that Y consists of Jill having a cow and Jack having a horse. Suppose further that X is the current allocation and that Jack and Jill can get together and strike a bargain without incurring costs such as hiring lawyers and paying postage and other "transaction costs" (that is, the costs of negotiating and making an agreement).

If Jack is willing to give Jill his cow in order to gain her horse, then he would be better off under Y . If Jill is willing to trade her horse to get Jack's cow, she too would be better off under Y . Accordingly, they will voluntarily exchange their possessions and move from X to Y . That move will be a Pareto-superior move, because it will produce an allocation that is Pareto-superior to the allocation from which they started. Whether it is Pareto-optimal will depend on whether they are willing to undertake any other exchange. If not, Y will also be Pareto-optimal.

The concepts of Pareto optimality and Pareto superiority are thus understood by economists in terms of economic exchange: each voluntary exchange produces an outcome that is Pareto-superior to the starting point (assuming that no one is affected other than the parties to the exchange), and the point at which no further voluntary exchange takes place (assuming no transaction costs) represents a Pareto-optimal distribution.

The Pareto criteria thus circumvent the problem of interpersonal utility comparisons by making the economic behavior of a person the measure of his or her well-being. Yet, certain difficulties make the criteria almost worthless in evaluating legal rules and systems.

The Limitations of Pareto's Efficiency Concepts

The first problem stems from the fact that economic exchanges typically have effects on third parties that can make them worse off. While a voluntary exchange makes the parties to the exchange better off—at least according to economic theory, it may make persons who are not parties to the exchange worse off. If I buy my groceries from Jill's store rather than Jack's, I might be making Jack worse off by increasing the profits of his competitor who could then use the extra profits to offer better services and take away more of Jack's business.

The Pareto criteria give us no way of comparing and evaluating the outcomes of such exchanges. As soon as even one person is made worse off by some transaction, the Pareto criteria are silent on whether the transaction produces an improvement or not. The starting point and outcome are noncomparable. Since most transactions have these third-party effects, the Pareto criteria are usually inapplicable.

Second, virtually any change in existing legal rules or social policies will produce some winners and some losers. It does not matter whether the change

is a radical one (such as replacing a command economy with a market one) or in the status quo will make at least one person worse off. This means that the Pareto criteria are practically useless for judging proposed changes in legal rules and policies, for the criteria will again be silent on the question of which is better, society before the change or after.

Kaldor, Hicks, and Posner

The severe limitations of the Pareto criteria have led some economic analysts of law to develop and employ yet another standard of efficiency: the Kaldor-Hicks criterion. According to this standard, the move from one allocation, X , to another, Y , is an improvement in efficiency if and only if those who benefit from the move gain enough extra benefits so that they could fully compensate those who lose out from the move. Fully compensating a loser means giving her enough benefits so that she is as well off as she was before the move from X to Y . The Pareto demand that efficiency improvements help at least some and harm no one is replaced by the requirement that overall improvements outweigh overall harm. To that extent, the Kaldor-Hicks standard is similar to the principle of utility, which allows trade-offs between the gains of some and the losses of others.

In addition, a leading economic analyst of law, Richard Posner, has proposed a way of interpreting Kaldor-Hicks that enables the criterion to avoid the problem of interpersonal utility comparisons. He calls his version of Kaldor-Hicks "wealth maximization," and it appears to give us the best of both worlds. We can use it to weigh the gains of some against the losses of others but without doing any interpersonal utility comparisons.

According to Posner's wealth maximization criterion, the efficient allocation of society's resources is the allocation that puts each resource in the control of the person who values it the most. And efficient legal rules are ones that serve to bring about such an allocation. But the degree to which a person values a resource is not defined in terms of the pleasure or happiness or satisfaction she would receive from possessing it. Such a definition would throw us back into the intractable problem of getting inside the heads of others. Instead, the value that a person places on possessing something is determined by her economic behavior: how much she is willing and able to pay to obtain it, if she does not already have it, or how much she asks for in order to give it up, if she does already possess it.⁴

Posner's wealth maximization standard is the most useful of the efficiency criteria that have been developed by economic analysts of law. Accordingly, when we discuss efficiency, the idea should henceforth be understood in terms of wealth maximization.

Scarcity and Efficiency

On the economic view, efficiency is important for virtually every human society because humans generally live under conditions of scarcity. Scarcity means that the resources we need to satisfy our preferences are too few for everyone to get all that they would prefer to have.

THE EFFICIENCY OF THE COMMON LAW

Does the law help society deal with scarcity by promoting efficiency? According to many economic analysts, the rules of common law do so: they are efficient in that they generally ensure that resources wind up in the hands of those who put them to their highest-valued use. In the next section, we will examine the descriptive claim that the common law is efficient. Later, we will turn to the claim that its efficiency is what explains why the common law has its particular rules.

The implication of scarcity is that some potential, preference-satisfying uses for a given resource must be denied when that resource is put to a different use. The efficient use of a resource by society means that the resource is allocated to the use(s) that has the highest value, as measured by how much people are willing to pay.

As we saw in Chapter 4, the common law consists of the judge-made system of legal rules that govern property, contracts, and torts. Although much of it was originally inherited from England, the common law underwent modification and development at the hands of American judges. Economic analysts of law often claim that the rules of common law, on the whole, lead to an economically efficient allocation of resources.

Contract Law

Promoting Efficient Exchange In order to promote efficiency, a system of legal rules must ensure that resources end up in the hands of those who place the most value on them. If you value my wheat more than I do and I value your corn more than you do, it is inefficient if I keep the wheat and you keep the corn. That is because the two resources, wheat and corn, are not in the hands of the people who value them the most. Economic analysts argue that market transactions are vital in promoting efficiency because the transactions help ensure that resources end up in the hands of those who value them the most.

Accordingly, an efficient system of law must have rules that enable persons voluntarily to exchange the resources they possess. In the common-law system, according to economic analysis, the rules of contract law help to ensure that resources get transferred to those who value them the most. The rules are especially important in those situations where the parties to a contract do not simultaneously exchange their respective goods.

For example, suppose that my wheat is ready for harvesting and delivery now but that your corn will not be ready until next month. We might enter a contract in which I deliver the wheat to you before you deliver the corn to me. When I deliver the wheat, though, I am in a vulnerable situation. Now that you have my wheat, you might be tempted to hold onto your corn. The rules of contract law aim to deter such inefficient behavior on your part and thus give me sufficient assurance to send you my wheat. Only in that way will the

economically efficient transaction occur. Accordingly, the rules of contract law provide that you must pay damages to me in case you breach our contract.

Suppose, however, that someone else who values your corn even more than I do gets in contact with you after I have delivered my wheat to you but before you have delivered your corn to me. She makes you a better offer for the corn than I made. Thus, it would be more economically efficient for that person to get the corn than for me to do so: she values it more. Does the law allow that to happen? Yes, because contract law only requires you to pay me the cash value of the corn to me. If you get a better offer for the corn from someone else, then you can pay me that cash amount and still have some left over for yourself. Everyone ends up better off, and economic efficiency is promoted.

Certain kinds of contracts are legally unenforceable, for example, those made as a result of duress. If you coerce me into signing a contract with you at gun-point, the law will refuse to enforce the contract. Economic analysts point out that the rule regarding duress is economically efficient. If I do not willingly enter into a contract with you for something I possess, economic analysts will conclude that you do not really value the item more than I do. If you did, then you would voluntarily pay me for it. For the economic analyst, a person's willingness to pay is the most reliable evidence of the value of something to that person.

According to economic analysts, it is not efficient for society's legal system to enforce every promise or agreement, even when we ignore the ones made under duress. Enforcement uses society's resources, and if it costs more to enforce a contract or promise than the net gain that accrues as a result of meeting its terms, society will have lost more than it gains. Economic analysts claim that contract law contains a doctrine that helps society avoid the inefficient enforcement of such promises and contracts, the doctrine of consideration.

The Doctrine of Consideration *Consideration* is defined by the law as something of value that is given or promised in exchange for something of value. If I offer to sell you my car and you promise to pay me \$500, then your \$500 and my car both count as consideration: in consideration of your money, I will give you my car, and in consideration of my car, you will give me your money. Consideration is the essence of the deal we make.

The doctrine of consideration says that in order for a promise or agreement to be legally binding, each party must give consideration for what the other gives (or promises). This means that "gratuitous" promises are not legally binding. Thus, suppose I promise to give you \$10 so you can buy a new compact disc, and I ask for nothing (and you offer nothing) in return. The promise is without consideration and so is gratuitous. It is not legally binding and so, in general, I may change my mind the next day without incurring legal liability. Does the doctrine of consideration promote efficiency? Economic analysts say yes. They claim that it excludes from legal enforcement relatively trivial "social" promises whose enforcement would be economically inefficient. After all, it uses up society's resources when you take me to court in a dispute over my promise to give you \$10 to buy a compact disc or when Joe takes Jane to court in order to settle a dispute about whether she promised to go out on a

date with him. The valuable time of judges, lawyers, and court employees could be more efficiently spent if such informal social promises were denied legal enforcement, which is what the doctrine of consideration does.

Economic analysts also argue that the doctrine excludes from enforcement those agreements that are so vague that the courts would, in effect, be required to define the terms. In order for there to be consideration, there must be a definite something—a sum of money or a specific item or a specific promise of such—that is given in the exchange. Where nothing definite is given or promised, the courts have no specific bargain to enforce. That means that the courts would have to set the terms of the bargain in order to enforce it. But that is largely inefficient because the parties themselves are in a much better position than the courts to say what contract terms make them better off. The parties know better what value they place on things and what it is worth to them to obtain the item that the other party is offering. As a general rule, efficiency demands that the parties to a contract set the terms themselves and that courts restrict themselves to enforcing the terms that the parties have set. Accordingly, the doctrine of consideration helps promote efficiency by telling potential contract partners, "You need to settle on the specific terms of the contract yourselves, and, if you fail to do so, we are not going to formulate the terms for you."

Contract law generally requires that there be consideration for a promise to be legally enforceable. But it also keeps courts out of the business of evaluating whether the consideration given for a particular promise is adequate. The law is concerned with the existence of consideration but not with its adequacy. In other words, the courts will not inquire into whether each of the parties to a contract is getting his or her money's worth.

Economic analysts argue that the law's refusal to consider adequacy is efficient. This is due to the fundamental economic principle that individuals are in the best position to say what something is worth to them. The principle helps explain why it is efficient for courts to insist on definite consideration before they will enforce a contract, but it also helps explain why it is efficient for them to avoid questions about the adequacy of consideration. If you are the one in the best position to say what something offered as part of a contract is worth to you, then the courts should not second-guess whether you are getting your money's worth.

Negligence and the Hand Formula

The common law not only sets the rules for the enforceable bargains people make. One of its important functions is to enable those injured by another's negligence to gain compensation. The tort law sets the rules covering negligent behavior, including the criteria that determine what behavior counts as negligent.

Negligence is ordinarily explained as the failure to exercise reasonable care in one's activities. But what level of care is reasonable? Economic analysts claim that the idea of efficiency can help answer that question. Reasonable care, they say, is economically efficient care.

Suppose that unusually cold weather causes the underground water pipe that I installed to burst, causing damage to your property. Was I negligent in not putting

the pipe deeper in the ground, where it would not have frozen and burst? The economic analyst will answer this question by comparing the cost of putting the pipe deeper to the expected cost of the burst pipe. The expected cost of the burst pipe is obtained by multiplying the probability that the pipe would burst by the harm done. Suppose that the probability of such a burst was 0.01 and that \$1,000 worth of harm was caused. That means that the expected cost of the harm was \$10. Suppose that it would have cost me an extra \$20 to have put the pipe deep enough to avoid the bursting. Then it would *not* have been "cost-justified" to have placed the pipe that deep: it would have cost more than its expected benefit of saving \$10. Taking precautions that are not cost-justified is not economically efficient. Suppose, however, that it would have only cost me \$8 to have placed the pipe deep enough to avoid the bursting. Then it *would* have been cost-justified to place the pipe that deep, and for that reason it would have been economically efficient to do so. Thus, I was acting in an inefficient way by not placing the pipe that deep, and according to the economic interpretation of negligence, I was being negligent.

The economic interpretation of negligence was first proposed by the famous judge Learned Hand. Judge Hand ruled that a defendant was negligent if the cost of precautions that could have prevented the harm she caused was less than the expected harm. Thus, the so-called "Hand formula" for negligence is that a defendant is negligent if and only if B is less than PL —where B = the cost of preventative measures, P = the probability of harm, and L = the harm caused.

Hand's formula is, however, not exactly correct, from an efficiency standpoint, because it is based on total costs rather than marginal ones. True economic efficiency does not merely require that the total cost of preventative measures be less than the total expected cost of the harm avoided. It requires that each additional dollar spent on prevention save at least one additional dollar in expected costs. Suppose that by an additional \$6 spent on my water pipe I could have reduced expected accident costs from \$10 to \$3. That represents a net saving to society of \$1 and so is efficient, at least compared to my spending no additional money on the pipes. But also suppose that the seventh extra dollar I spend would only bring down the expected accident costs by another \$0.50. Then it would be inefficient for me to spend seven extra dollars. I should only spend \$6 (at most), since the marginal benefit of that seventh dollar is less than a dollar. On the economic view, then, the common-law doctrine of negligence promotes efficiency by encouraging persons to take cost-justified measures to prevent harm to others. It holds them liable for carelessness if but only if they failed to invest resources in prevention up to the point where additional investment would cost as much or more than the expected marginal savings.

Property

In addition to negligence and contracts, an important part of the common law covers the ownership and use of property. Economic analysts claim that these common-law rules are efficient as well. Consider the rule that a property owner owes no duty of care to a trespasser. If I own land that has hidden pits and crevices on it, the common law

does not require me to post signs that would warn trespassers of the danger. Suppose you come onto my land without my consent and fall into a pit, injuring yourself. Under the common law, I am not liable for the harm, since you are a trespasser, regardless of whether I was negligent in failing to fill in the pit or take other precautionary measures.

The economic understanding for the rule is that it promotes efficiency because the trespasser can generally avoid the cost of injury more cheaply than the landowner can: he need only refrain from trespassing, which will usually cost less than my filling the pit, putting a fence around it, or taking some similar precautionary measure. Requiring the trespasser to shoulder the costs of the injury creates an incentive for potential trespassers to refrain from that kind of illegal action. And since the potential trespasser can take measures to avoid the costs of trespassing injuries more cheaply than can landowners, efficiency is thereby promoted, according to economic analysts.

The trespassing example can be generalized to cases in which both parties are engaged in perfectly legitimate activities. In many types of disputes, the uses of which two people put their respective pieces of property end up causing harm to one of the properties. It is efficient for the harm to be avoided, but this can be accomplished only if one of the parties alters his use of his property. Economic analysis says that in such cases of "incompatible" property use, the common law typically assigns rights to the parties based on which one can take steps that avoid the harm more cheaply. The cheaper "cost avoider" is given the burden of altering his use of his property, while the other party is given the legal right to continue using his property as he has been.⁵

Suppose a railroad emits sparks and that, once in a while, the sparks will cause a fire that burns down the crops on a farm adjacent to the railroad. The railroad could prevent the sparks by slowing its speed by 15 mph. But that slowdown will cost the railroad \$100 in revenues. The farmer could prevent the fires by not planting on land within thirty feet of the tracks. But not planting on that land will cost the farmer \$50 in revenues. The common law will, according to economic analysis, give the railroad the right to emit sparks and put the burden of avoiding fires on the farmer, the cheaper cost avoider. The farmer will have no choice but to refrain from planting crops within thirty feet of the tracks.

THE COASE THEOREM

One of the more surprising ideas of the law and economics movement concerns cases of incompatible property uses, like the railroad and farmer example. The idea is that in these cases, the property owners would invariably arrive at the efficient outcome, regardless of how the law assigned rights, as long as there are no transaction costs and the owners cooperatively negotiate a solution to their dispute. For example, even if the law denied to the railroad the right to emit sparks and assigned to the farmer the right to grow crops next to the tracks, the efficient outcome would still occur. How is that possible if it is

inefficient for the farmer to have the right to grow crops adjacent to the tracks and thus prevent the railroad from emitting sparks?

The answer stems from the fact that the railroad could and would buy the farmer's right from him. It is worth \$100 for the railroad to be able to emit sparks, since that is its marginal benefit from traveling at a speed that would emit sparks. It is worth \$50 for the farmer to grow crops within thirty feet of the tracks, since that is the marginal benefit of planting on that land. If the farmer is given the right, then the railroad could offer him something between \$50 and \$100 to refrain from growing crops on land within thirty feet of the tracks. The farmer has incentive to take such an offer, because he would be able to get more than the \$50 he gets from planting on that land by making the deal. And the railroad has incentive, because it would then be able to earn an extra \$100 in revenues from running at a higher speed. If there were no transaction costs and neither party stubbornly held out for a better deal (for example, the farmer did not hold out for a price of \$99.99 and the railroad did not hold out for a price of \$50.01), then both parties would arrive at a mutually acceptable price that allowed the railroad to run its trains at spark-emitting speed.

More generally, a theorem of the economic analysis of law is that an efficient allocation of resources will occur through market transactions, even if the initial allocation made by the law is inefficient, as long as transaction costs are zero and the parties negotiate cooperatively. This is called the Coase theorem, after the man who discovered it.

It may seem that the theorem has a paradoxical consequence for the main explanatory thesis of the law and economics movement. That thesis, which we will explore in detail shortly, holds that the efficiency of common-law rules is what explains why we have them. The Coase theorem seems to render such an explanation silly. For the theorem entails that efficiency will result no matter what the common-law rules are. If the goal is efficiency, it does not seem to matter whether the legal rules themselves assign rights and resources in an efficient way. However, three crucial points must be kept in mind before concluding that it does not matter if common-law rules are efficient. First, market correction of inefficient allocations is possible only if legal rules allow the market transactions that make the corrections. So to the extent that we are assuming that society eventually produces efficient allocations, legal rules must promote such efficiency by allowing for the market correction of legally generated inefficiencies. This is why economic analysts regard rules governing economic exchange as vitally important in promoting efficiency.

Second, in the real world there are transaction costs. The costs involved in negotiating and entering an agreement include the costs of identifying and contacting the other parties, the cost of the time spent negotiating, the cost of lawyers, the cost of drawing up the documents, and so on. In some cases, transactions costs are so high that the law cannot rely on the market to correct inefficient allocations. The law needs to get the allocation right, the first time. Third, in some situations, incentives for hold-out behavior decrease the chances for a Coasian bargain that corrects for legal mistakes. If the railroad had to negotiate with many farmers instead of just one, some of them might try to

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take advantage of the situation. They might wait until the railroad had deals with most of the others farmers and then hold out for the highest possible price. In such a situation, the few hold-outs would have great bargaining leverage against the railroad, since the railroad would not be able to run its trains consistently at the higher speed unless it had an agreement with every farmer. But if enough farmers adopt a hold-out strategy, such behavior could scuttle any deal with the railroad and result in the railroad running its trains at the lower speed. That would be an inefficient outcome. In contrast, an efficient legal rule would respond to the hold-out problem by simply assigning to the railroad at the outset the right to run trains at the spark-emitting speed.

We have seen that there are many rules of common law that economic analysts describe as promoting efficiency. Let us assume for the moment that the descriptions are right and that the rules of common law largely promote efficiency. Is there reason to conclude that their efficiency is what explains the existence of the common-law rules?

Economic analysts of the law answer in the affirmative. They contend that the common law is (largely) efficient, but they also claim that its efficiency explains why it contains the rules it does. The latter claim, however, needs to be supported by additional argument, over and above whatever arguments may establish the efficiency of the common law. Even if we grant that the common law is efficient, it does not automatically follow that its efficiency is what explains it.

Posner's Argument

Richard Posner presents one argument for the efficiency-based explanation of common law. It rests on two key premises (aside from his descriptive thesis that common law is largely efficient). First, a social consensus holds that efficiency is a good thing for society. Second, the common law is an ineffective way to redistribute the resources of society in order to assist some politically active interest group. In Posner's view, the truth of the first premise inclines the judges who fashion the rules of common law to make them efficient. And the truth of the second premise means that no significant countervailing force will incline judges to assist some particular interest group at the expense of economic efficiency. The upshot is that judges will fashion the common law so as to make it (largely) efficient.

Let us grant for the moment that there is a social consensus in favor of efficiency. Why does Posner argue that the common law cannot be effectively used for redistributive purposes? He claims that any efforts to use the common law to benefit a certain interest group at the expense of efficiency will be canceled out by the economic behavior of the parties involved. For example, suppose that

a judge wants to help tenants at the expense of landlords by fashioning common-law rules that make it more difficult for landlords to evict tenants who do not pay their rent. Posner says that landlords will simply cancel out the intended effect of the new rules by raising their rents to cover the extra losses. Or suppose that a judge wants to help make railroad rules that make railroad liable for damage to crops caused by sparks. The railroad will simply raise the rates they charge to cover the additional expense, and farmers will end up paying more to get their crops to market. Posner is not arguing that all redistributive efforts always fail due to the economic behavior of the affected parties. He is arguing that redistributive efforts that rely on the common law will fail. But he concedes that efforts relying on legislation, say the tax code, may succeed. Funding food stamps by taxing the rich at a higher rate than the poor may indeed succeed in redistributing resources from the well-off to the poor. The difference with common-law rules, for Posner, is that they are unable to work like the progressive income tax scheme. And with redistribution out of the common-law picture, the inclination of judges to promote the agreed-on value of efficiency will operate largely unhindered.

Criticisms of Posner

The basic problem with Posner's argument for an efficiency explanation of the common law is that it does not take adequate account of the possibility that noneconomic reasons exist for the common law and that it just so happens that the rules that stem from those noneconomic reasons are also largely efficient. For example, many legal thinkers explain the rules of common law in terms of moral, rather than economic, principles and concepts. They contend that the rules are to be explained in terms of society's judgments about justice and fairness, not its judgments about the most efficient use of resources. Assuming that Posner and other economic analysts are right that the common law is efficient, its efficiency might only be a side effect, not the true basis, of the law.

Posner responds to the claim that social morality, not economics, explains the rules of common law by arguing that principles of morality and fairness typically promote efficiency. Honesty and industriousness, for example, are not only regarded as moral virtues in our society; they are also economic virtues because they help efficiency.

But even if Posner is right about the efficiency of society's moral rules, he is missing the point. The question is whether social morality or economic efficiency (or both, or something else entirely!) explains the common law. Pointing out that social morality is generally efficient, even if true, does not answer the question, much less establish that the correct answer is "economic efficiency."

Social Morality versus Efficiency

Any explanation of legal rules in terms of social morality has one major advantage over a competing explanation in terms of economic efficiency. As we have emphasized at several points, positive law is made and maintained by the human beings who make up a society. And human beings generally think and make

judgments much more readily and more often in terms of their social morality than in terms of economic efficiency. Indeed, very few people ever think or make judgments in terms of economic efficiency in its Kaldor-Hicks sense. The upshot is that explaining any area of law in terms of social morality need not go beyond what persons ordinarily and often do, while explaining the law in terms of efficiency does not permit such a simple and direct route.⁶

If economists made the law, then it might be reasonable to expect that it could be explained in terms of its efficiency. After all, economists often, if not always, think and make judgments in terms of that concept. But economists do not make the law, and an efficiency explanation relies on a concept that is not in the conscious thinking of those persons who do make it. The idea of efficiency is, for the most part, "external" to the deliberations and decisions of legislators and judges. Unless there is some strong reason to think that such an "external" concept better explains the law than the "internal" concepts of society's morality, it would seem that the social-morality approach is more plausible.

What would count as a strong enough reason? In scientific inquiry, hypotheses that are contrary to common sense often end up confirmed as true. Common sense says combustion is a process in which some substance is driven out of the burning material. Scientific inquiry says that combustion is a process in which oxygen combines with the burning material. Could it be the same with legal rules, that common sense says social morality, not efficiency, explains the common law, but scientific inquiry says common sense is wrong? Undoubtedly, the proponents of law and economics would like to think of their enterprise as "scientific," but there are reasons to doubt that it has achieved that status.

THE SCIENTIFIC STATUS OF LAW AND ECONOMICS

Scientific Method

Scientific hypotheses are put to the test of experimental confirmation. The experiments are based on predictions logically derived from the hypothesis and statements describing the experimental conditions. The predictions anticipate events (or conditions) that are not likely to occur (or exist) unless the hypothesis is true. And the predicted events must be publicly observable: whether they actually occur must not be subject to reasonable disagreement. If the events do indeed occur as predicted, then the hypothesis is confirmed. Before the hypothesis is accepted by the scientific community, though, the experimental result must be replicated by independent investigators. The requirement of replication serves as an additional check against the influence of personal bias. The point of scientific experimentation is to confront any hypothesis with the facts making up the world in such a way that the scientific enterprise becomes self-correcting and consensus-generating. False hypotheses are eventually revealed as such, and the scientific community comes to general agreement on hypotheses that are (approximately) true.⁷

Is Law and Economics Scientific?

How well does law and economics measure up to the standards of scientific inquiry? Is there anything in the law and economics approach that is analogous to experimental confirmation? Earlier it was suggested that there is no commonsensical reason to expect that the rules of common law will turn out to be economically efficient. Suppose we treat that as the "prediction" of law and economics: it will turn out, contrary to commonsensical expectations, that the rules of common law are generally efficient. The "experimental" test will then be whether it can be shown that the various rules are efficient. To the extent this can be shown, it counts as experimental confirmation of the hypothesis that efficiency is what explains the common-law rules.

However, there are two serious problems with this way of trying to make law and economics "scientific." First, the "experimental test" looks more like a test of the ingenuity of the proponents of law and economics than a test of the truth of their hypothesis that efficiency is what explains the common law. Undoubtedly, Posner and his colleagues have displayed great ingenuity in arguing that various common-law rules are actually efficient. But these arguments are hardly equivalent to experimental confirmation in science. There is nothing analogous to a publicly observable event, whose occurrence or nonoccurrence is beyond reasonable disagreement. Instead, there are arguments containing a great deal of conjecture, assumption, and interpretation. At best, the arguments show that it is a plausible hypothesis that common-law rules are efficient. But they do not confront that hypothesis with facts in the world in anything like the way that scientific experimentation does.

Consider the economic analysis of the common-law rule that says a property owner has no duty to warn a trespasser of hidden dangers on her property. That analysis claims that the rule is efficient, because it costs less for a person to refrain from trespassing than for an owner to warn anyone on the land of the dangers. Perhaps that analysis is accurate. But perhaps the rule is actually inefficient, because in many cases it might be cheaper for an owner to put up a warning sign than for a trespasser to determine the exact borders and nature of the owner's property. What law and economics gives us is no more than a plausible hypothesis.

A second problem with the attempt to make law and economics scientific concerns the "prediction" that, contrary to common sense, common-law rules will turn out to be efficient. This "prediction" fails the requirement that it be unlikely to turn out true unless the hypothesis is true that the common law is explained by its efficiency. It could well turn out that the common law is generally efficient, even if its efficiency is not what explains it. This is because efficiency may well be a by-product of what does provide the best explanation of the common law.

Suppose that common-law rules substantially reflect social morality and that the rules also are largely efficient. Posner assumes that this supposition could be true only if social morality is explained by its efficiency. If he were right and the supposition were true, efficiency would be the underlying explanation of the common law. Common sense would not be so much wrong as superficial in its

social-morality explanation. For there would be something underlying social morality, efficiency, that provides the deeper explanation of the common law. Yet, it is entirely possible that the common law is efficient because it substantially reflects social morality. Contrary to what Posner assumes, social morality may be more fundamental than efficiency and may explain both the content of common law and why it is efficient.

Recall that what is efficient depends on the preferences of individuals in society. Social morality could play a large role in determining individual preferences. Obviously not all preferences conform to social morality—or else no one would ever do anything regarded as wrong by the lights of social morality. But it is also true, if less obvious, that many of our preferences do conform to social morality. For most people, there are costs to having preferences that go against that morality—a guilty conscience, disapproval of one's friend and acquaintances, criminal sanctions in some cases—and these costs could play a substantial role in forming and shaping our preferences. And for most people, having preferences that conform to social morality offers benefits: there is a better chance of getting what one prefers. Again, such benefits could decisively shape our preferences.

Suppose it turns out, then, that the free market established by the rules of contract law is efficient. This outcome might simply reflect the fact that social morality encourages preferences that can be better satisfied through such a market (for example, preferences for consumer goods) and discourages ones that are more difficult to satisfy through the market (for example, preferences for democratic processes in the workplace). Social morality would provide the best explanation of both the common law and its efficiency.

This possibility does not show that Posner and his cohorts are wrong when they claim that economic efficiency is what explains the common law. Yet, at this stage in our understanding of the law, the idea that its efficiency is what explains the common law remains a suggestive but unconfirmed hypothesis.

THE EVALUATION OF LAW:

SHOULD LAW MAXIMIZE WEALTH?

We now turn to the evaluative aspect of the law and economics movement: its claims about what the law should be. Like the explanatory claims, the evaluative ones revolve around the idea of economic efficiency. According to the economic analysts, the idea enables us to compare the effects of adopting different legal rules and, by such comparison, to evaluate the rules.

The Biggest Pie?

A standard claim of the law and economics movement is that efficient legal rules create the "biggest economic pie." Various interest groups may fight one another over how the slices of the pie are to be distributed, but it is in everyone's interests to have legal rules that create the biggest pie. After all, the more

there is to fight over, the better off everyone seems to be. For that reason, economic analysts say that efficiency is a "neutral" value that all can endorse, whatever their differences about the just or fair distribution of resources. And for that reason, economic analysts claim that efficient legal rules are, insofar as they are efficient, good legal rules.

The claim that efficient legal rules create the biggest pie seems to be conflicting the idea of efficiency as wealth maximization with a very different idea of efficiency. That different idea can be called "productive efficiency," which can be explained in terms of a simple example.

Imagine a society whose sole product is widgets. The society faces a choice between mutually exclusive legal rules *A* and *B*. Suppose that the choice of rule *A* will lead to a higher output of widgets per work hour. We can then say that *A* has greater productive efficiency than *B*.

Legal rules can promote productive efficiency in a number of distinct ways. For example, they may create incentives for society's laborers to work harder or faster in a given period of time. Or they may create incentives for persons to come up with technological innovations that increase the output of a given period of labor time. Or they may create incentives for persons to invest in available technology that increases the output of labor.

The idea of productive efficiency is logically distinct from that of wealth maximization. For a society to have the highest possible output per work hour is one thing; for it to allocate goods and services into the hands of those who value them the most, as measured by their willingness and ability to pay, is quite different. When economic analysts of law refer to the size of the pie, sometimes they are referring to productive efficiency and sometimes to wealth maximization, and it is not always clear which one.

Moreover, it would seem misleading to refer to wealth maximization as the creation of the biggest pie possible. For the concept of wealth maximization is about who gets what slice; it is not about the overall size of the pie. Strictly speaking, it would be more accurate to claim that wealth maximization ensures that each person gets the particular slice of pie for which he or she is willing and able to pay the most.

However, Posner would argue that there is an empirical connection between wealth maximization and productive efficiency. The connection stems from the fact that the slices of the pie are economic goods that can be used to make other goods (used to "grow" the pie). The degree to which I value some good will depend, at least in part, on how productively I can use it. The more I can make with it, the more value it is to me. And when I obtain the good through market transactions, I have every incentive to use it as productively as I can, for such use maximizes its value to me.

Other Virtues of Wealth Maximization?

In Posner's view, the wealth maximization standard has many other virtues in addition to promoting productive efficiency. Among the most important is that it provides a stronger support for individual rights than utilitarianism. Consider slavery. Slaves do not have any legal right to their own labor: they must work

for the master and cannot decide to withhold their labor or to work for someone else who is offering a better deal. Our belief that no one should be a slave rests on the idea that everyone has a moral right to their own labor. But what is the basis of such a right? Utilitarianism bases the "moral right" on the claim that slavery fails to maximize the net balance of pleasure over pain.⁸ But Posner regards that as a weak basis: there could be circumstances in which the pleasure of the slave owners and their families outweighs the pain of the slaves. He suggests that maximizing wealth, as opposed to utility, provides a stronger basis for the right to one's own labor.

The value of a slave's labor is much greater to the slave than to the owner. After all, everything the slave produces goes to the owner, with nothing to the slave. This reality creates a powerful incentive for the slave to work very unproductively. In contrast, as a free person with a right to his own labor, the individual has a strong incentive to work as productively as possible. This means that a person's labor is of greatest value to himself, and so maximizing wealth requires that the right to such labor be given to the individual and not to anyone else.

This conclusion of Posner's may seem a bit bizarre in light of the fact that he insists that the value of something to a person is a function of how much they are willing and able to pay for it. If a slave has nothing to pay for his freedom, does it not have zero value to him, given Posner's criterion for measuring value?

Posner's answer is that the slave can borrow the amount of money that represents the value of his freedom to him. That amount would be more than the owner would be willing to pay to keep him a slave, and so wealth maximization requires that the right to a person's labor be assigned to the person himself rather than to someone else. The fact that a slave who is forced to borrow to buy his freedom would have a large debt is irrelevant in Posner's view. For wealth maximization tells us that we should assign to every person the right to freedom from the beginning. The borrowing scenario is simply a hypothetical device that helps us determine who values the slave's freedom more—the owner or the slave himself—and thus enables us to determine whether there is moral right to freedom or a right to own slaves.

Wealth Maximization and the Poor

Some critics of Posner charge that the wealth maximization standard is biased against the poor in society. They point out that a person's willingness and ability to pay for something is a function of his or her wealth. The wealthy are in a position to shell out more money for something than the indigent (or to borrow more, if they do not have enough cash on hand), and so they will end up getting much more of society's goods and services if Posner's wealth maximization standard is used. The fact that an indigent person may desire some good much more than a wealthy person or may derive much more pleasure from it is irrelevant according to Posner's standard. Yet for Posner, one of the strengths of wealth maximization is that it does not allocate goods based simply on the intensity of a person's desire for it or

the amount of pleasure she would receive from it. Such utilitarian bases for allocation flout an important moral intuition: people are not entitled to goods simply by virtue of wanting them or getting pleasure from them. Posner believes that people should have to work for what they get, and wealth maximization reinforces this work ethic. Wealth maximization supports a market society (recall the efficiency of market transactions), and in such a society the wealth of persons is generally a reflection of their productive labor. At least that is Posner's view of the matter.

The claim that wealth maximization is biased against the poor is one aspect of a broader criticism of the evaluative side of the economic approach to law. According to that criticism, reliance on notions of economic efficiency for evaluating the law is biased in favor of a right-wing political agenda. Efficiency-based recommendations, it is charged, invariably favor the sorts of solutions to social problems that political conservatives advocate.

Efficiency and the Welfare State Posner's claim about how the market rewards the work ethic is dubious: many thinkers, including conservatives, have pointed out how success in the market is often more a matter of luck than of any work ethic. But even if we reject Posner's claim, the general charge that the economic analysis of law exhibits a political bias is mistaken in a number of key respects. First, it is simply not true that efficiency-based recommendations invariably favor conservative solutions over liberal ones. Consider, for example, the question of whether government should operate a welfare program to prevent the poorest from starving or suffering similar serious deprivation. Liberals have, of course, been strong advocates of such welfare policies. Conservatives tend to be skeptical or downright hostile toward them.

Yet, Posner quite plausibly points out that a welfare system could well be justified on the basis of economic efficiency. Private charity is likely to prove insufficient, and starving persons will not generally die quietly in the street. They will commit crimes in order to feed themselves and their children. It may well be more efficient economically to establish welfare programs to ensure that such persons are fed than to leave them no choice but to feed themselves through criminal activity. That is because crime creates very heavy social costs: people spend a great deal to avoid being crime victims (buying alarm systems, not going out at night, and so on), and society spends a great deal investigating and prosecuting crimes and in imprisoning offenders. Running a welfare system may not be cheap, but it may well be cheaper for society than paying the increased costs of crime that would ensue were there no welfare system.

Another efficiency reason for some kind of a welfare program is rooted in the altruistic desires of many citizens. These citizens have a preference that their fellow citizens not suffer from drastic deprivation. If enough people who are well-off have such a preference, then a welfare program might be called for on efficiency grounds. It may be asked why efficiency cannot be served by having altruistic citizens donate to private charity. What is the need for the liberal, government-imposed

POLITICAL DISAGREEMENT IN LAW AND ECONOMICS

What Kind of Market?

Posner points out that there is an efficiency-based justification for reliance on government in this context. Although a well-off person may rarely want to see all the poor fed, the donations to private charity of others may make her contribution unnecessary. And her contribution, by itself, will not determine whether there are enough total contributions so that all the poor can be fed. Thus, a rational incentive exists for the well-off person to hold back from giving to private charity—in the hopes that others will give and make her contribution unnecessary—so that she can be a “free rider.” As a free rider, she would get what she wants—all the poor fed—but not have to pay for it. But since each well-off person would have a rational incentive to refrain from donating so she could be a free rider, the result is likely to be a lower level of actual charitable contributions than would be efficient. And as Posner points out, government action solves this free-rider problem by financing a welfare program out of taxes that the well-off person has no choice but to pay.

There are many social problems in which a free-rider analysis can lead to liberal solutions. Environmental problems are rife with free-rider considerations, and many proponents of law and economics argue that strict environmental laws of the sort typically favored by political liberals are needed to promote efficiency. This is not to say that there is unanimity among the proponents of law and economics on environmental issues or any other politically controversial topic. But that very point takes us to the nub of the problem with the claim that law and economics has an inherent conservative bias: many proponents of law and economics use its ideas to advocate liberal solutions to policy issues.

The views that economic analysts of law have on current issues span the political spectrum from liberal to conservative. There is general agreement among them that Kaldor-Hicks efficiency is a politically neutral value that society should take account of in developing its law. And the free market is uniformly endorsed as the main engine of the economic system. But there are serious disagreements as well that lead to very different conclusions about what kinds of legal policies society should adopt. Roughly, we can distinguish between a conservative and a liberal side to the law and economics movement. The two sides disagree over the extent to which the market should be left to operate free of legal interference and regulation. The liberal side advocates greater legal regulation and interference than does the conservative. The disagreement is rooted in conflicting conceptions of the efficiency and morality of unregulated market outcomes.

Conservatives versus Liberals

Those on the conservative side of the law and economics movement tend to think that the market almost always produces efficient outcomes and so is only rarely in need of legal correction in order to achieve efficiency. They do not reject the existence of transaction costs and other factors that interfere to some extent with the efficiency of market operations. But they judge that such interferences are usually minimal and that legal efforts to alter market outcomes usually create more inefficiency than they correct.

In contrast, the liberal side sees a greater need for legal correction of the market. It holds that transaction costs, free-rider problems, and other factors that interfere with market efficiency are more extensive than the conservative side admits. And it believes that legal regulation or circumvention of the market can effectively counteract such costs and problems and yield efficient outcomes for society.

In addition, those on the liberal side tend to subscribe to theories of justice that claim the priority of justice over efficiency and that require substantial redistribution from the outcomes produced by the market, even when the market is operating efficiently. For example, their theories of justice generally hold that government must provide significant assistance to the indigent and significantly reduce the disparities in wealth and income that result from the operation of market forces.

In contrast, those on the conservative side either deny that justice is a value that can take priority over efficiency or else hold a theory of justice according to which market outcomes are essentially just. Thus, the conservatives argue that, when transaction costs do interfere with the efficiency of market exchange, the law should generally "mimic the market." In other words, the law should produce the same outcome the market would have produced had transaction costs not interfered.

Conservatives who deny that justice takes priority over efficiency tend to be skeptical of all value judgments other than those about efficiency and to adopt a "deflationary" attitude toward such judgments. They regard judgments about justice and other moral values as no more than expressions of personal preference. Such subjective moral preferences can be incorporated along with all the other preferences people have in order to decide what is most efficient, that is, what maximizes the satisfaction of preferences. But these law and economics conservatives doubt that justice and other moral values can provide legitimate constraints on the pursuit of efficiency.

Notice that this deflationary attitude toward values other than efficiency sharply distinguishes these law and economics conservatives from many of the political groups in society that are regarded as conservatives. For example, consider fundamentalist religious groups that favor state-sponsored prayer in school, oppose homosexual rights, reject abortion, and otherwise argue that moral values must be enforced by the government. Such groups do not conceive of the moral values they advocate as personal preferences to be cranked into the efficiency equation along with the differing personal preferences of their political opponents. Rather, they think of their moral

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values as the true ones and as disqualifying from consideration any preferences that conflict with those values. Such persons might consistently adopt the other elements of conservative law and economics: the efficiency of markets and so on. But they would have to judge that, where market transactions would violate their moral values, the market must yield.

Some law and economics conservatives reject the deflationary account of justice and morality. They believe that justice is the primary value to which social institutions must conform. But they wind up with the same conclusion that the deflationary conservatives endorse: the free market should be largely left alone to operate without legal interference or regulation. This is because they hold to a theory of justice that says that market outcomes are largely just. Liberals, in turn, will counter with a view that questions the justice of market outcomes.

In that respect, advocating efficiency is very different from advocating a pro-life or pro-choice position on abortion or advocating in favor of or against homosexual rights. The values relating to abortion and sexuality are controversial and cannot be agreed on by all in society. In contrast, Kaldor-Hicks efficiency is said to be a value all can agree to, even if there are other and more controversial values that each group in society also wishes to pursue. But are the law and economics advocates correct in their view of Kaldor-Hicks efficiency?

The main argument of these economic analysts hinges on a distinction between the total value of society's economic pie, on the one hand, and how the pie is sliced up and distributed among the different groups in society, on the other. Making the pie as valuable (that is, as big) as possible is one goal; dividing it up in a certain way is another. Everyone in society can agree on the first goal, even as they disagree over what the second one should be and work out their disagreements in the political arena.

The distinction between maximizing the value of the economic pie and distributing the slices of the pie in a certain way is unobjectionable as a matter of logic. However, it cannot be relied on to claim that it is in everyone's equal interest for society to maximize efficiency. That is because one cannot assume that, once Kaldor-Hicks efficiency is achieved, all interest groups have a real shot at winning the political game of distribution. Such an assumption glosses over the fact that certain groups in society have a decided advantage when it comes to dividing up the extra pie. In particular, those groups that are

already economically well-off are likely to have a great advantage in the political game that determines how the fruits of increased efficiency are to be distributed. The argument that Kaldor-Hicks efficiency is a politically neutral value is thus blind to the fact that economic wealth confers political power and that society is structured so that certain groups are much more likely than others to gain the extra benefits of increased efficiency.

The argument is also blind to the fact that the burdens of maximizing the total value of the pie are likely to fall disproportionately on the shoulders of certain groups in society. For example, efficiency might be maximized by having certain groups of workers do more in less time with the same technology, just as society is structured so that the extra benefits of increased efficiency are likely to be enjoyed by certain groups, it is structured so that the burdens of producing those extra benefits fall on certain groups. And it is unlikely that those who get the extra benefits will be those who bear the extra burdens.

Another argument for the neutrality of efficiency is tied to the deflationary view of moral values held by some in the conservative wing of law and economics: all such values are personal preferences to be cranked into the efficiency equation to determine which legal rules ensure the maximum level of preference satisfaction in society as a whole. No values are given special status or privilege in the efficiency equation: preferences in favor of homosexuality are treated on a par with those against it; preferences against abortion are treated on a par with those in favor of allowing women the choice of abortion. Since all values are treated equally, the efficiency equation is neutral.

This argument poses a big problem, however. To adopt the deflationary view of morality and justice is already to be biased against the views of those who think that justice and morality impose constraints on the pursuit of efficiency. The deflationary view is itself just one among many in society. When society adopts and acts on that view to the exclusion of others, it lacks neutrality just as much as when it adopts and acts on a particular conception of justice or morality. For society has then elevated one view and its preferred value of efficiency over all other views and values. Whether or not the pursuit of efficiency is justified, it is not politically neutral.

THE VALUE OF EFFICIENCY

Dworkin's Critique of Efficiency

If Kaldor-Hicks efficiency is not a neutral value, can it be regarded as an important social value at all? Ronald Dworkin expresses great skepticism about the value of Kaldor-Hicks efficiency, at least when interpreted according to the wealth-maximizing idea that the value of something to a person is determined by how much he or she is willing and able to pay for it. Dworkin argues that there is nothing intrinsically good about Kaldor-Hicks efficiency, and (2) any interesting claims about its instrumental value are dubious.

Advocates of the evaluative side of law and economics agree that there is nothing intrinsically good about ensuring that things end up in the hands of those who value them the most. Instead, they rest their case on the instrumental value of efficiency, not its intrinsic value. The pursuit of Kaldor-Hicks efficiency by our legal and political institutions will, they believe, bring important benefits to society: a higher average standard of living, better protection for individual rights, and greater reward for virtues such as industriousness and diligence. According to law and economics advocates, these benefits of efficiency are why it should be used as a standard to evaluate legal rules.

Dworkin counters this view by distinguishing two claims. First is the claim that sometimes the pursuit of efficiency in the law is the best way to bring about some important social benefit. Second is the claim that the single-minded pursuit of efficiency in some area of law (or law as a whole) is always the best way to bring about some important social benefit.

Dworkin regards the first claim as trivial: no sensible person would doubt that in some cases doing the efficient thing will benefit society. If that is all the advocates of law and economics mean when they say that Kaldor-Hicks efficiency should be an evaluative standard for the law, then their view is not false but trivial and uninteresting.

Dworkin regards the second claim as interesting but unproven and implausible. It is much more sensible to believe that the best way to protect individual rights, for example, is not by pursuing efficiency but by directly granting people their rights. Sometimes it is best to approach a goal indirectly. Baseball players often say that trying to hit a home run is a bad way to go about actually hitting one: instead you should simply keep your eye on the ball and try to make contact. Dworkin concedes that a similar indirect strategy may sometimes mean that promoting efficiency is the best way bring about some intrinsic social good. But it strains belief to hold that the only goal that the law should ever aim at directly is Kaldor-Hicks efficiency.

Taking Efficiency Seriously

Defenders of the evaluative side of law and economics can agree with Dworkin that it is trivial to hold that pursuing efficiency sometimes brings social benefits and implausible to hold that efficiency is the only goal that the law should ever aim to promote. But they can argue that there a great deal of room between the trivial and the implausible for an evaluative standard of efficiency. Kaldor-Hicks efficiency, they can contend, is an important evaluative standard for the law to use: it is not the only standard that it should be largely ignored. Efficiency is not all-important, but it should be taken seriously. This counter to Dworkin requires giving up the deflationary view of values other than efficiency. If efficiency is not all-important, then there must be other important values that are irreducible to efficiency. But the counter also raises a crucial question. How important is Kaldor-Hicks efficiency? How seriously should it be taken? At this point, I think there is no alternative but for

the law and economics movement to shift gears. It must go beyond its formal economic principles and make explicit the tacit interpretation of human history and society that underlies it.

The importance that the movement places on efficiency stems from a certain understanding of history, especially the history of the twentieth century. According to that understanding, some societies almost entirely ignored efficiency, and the results were catastrophic for them; while others took efficiency seriously, with largely beneficial results. In the first category, for example, are the old Soviet Union and Eastern bloc, and, until recently, China. The results of refusing to take efficiency seriously were economic stagnation, political repression, and a culture of sloth and indolence. In the second category are the United States and other Western industrialized nations (at least during certain periods). The results of taking efficiency seriously have been economic growth, political liberty, and a culture that values hard work and innovative thinking. This is, of course, a very oversimplified account of history and even a caricature of it. But it brings into bold relief the essential understanding of history that leads the advocates of law and economics to insist that efficiency be taken seriously.

Dworkin might respond by pointing out that interpretations of twentieth-century history do little to settle disputes over how important efficiency is as an instrumental value. For example, some thinkers interpret history as suggesting that the welfare state does not take efficiency seriously enough; though not nearly as bad, the welfare state is similar to communist regimes in creating economic stagnation and a culture of sloth. Others reject that interpretation and argue that the welfare state does take efficiency seriously enough. This disagreement over how to interpret the history of the welfare state may be one of the sources of the divisions between the conservative and liberal wings of the law and economics movement. The two wings clearly differ in the importance they accord to Kaldor-Hicks efficiency as a normative standard for law, and it is doubtful that any move to history can resolve those divisions. Rather, the move will simply lead to conflicting historical interpretations.

So it does seem true that looking to history to provide a definitive resolution to the question of how seriously efficiency should be taken is bound to fail. Yet, looking to history can still lead us to conclude that taking efficiency seriously is important. Advocating Kaldor-Hicks as an evaluative standard for law need not be seen in terms of Dworkin's stark dichotomy: either it is trivial or implausible. It can be seen as occupying a middle ground. When that middle ground is specified more clearly, it will turn out to be contestable. It will rely on judgments about history and society that are open to question and challenge. Law and economics advocates may be reluctant to make their stand on such contestable terrain. Yet, if they wish to vindicate their evaluative standard from Dworkin's dichotomy of triviality or implausibility, the advocates of law and economics have no choice.

NOTES

1. Accordingly, economists sometimes talk of costs and benefits in terms of preference satisfaction.

2. Philosophers and economists refer to this phenomenon as "decreasing marginal utility." In this context, the term *utility* is equivalent to benefits.

3. One way in which real people fall short of perfect rationality is that all of us sometimes act on the basis of false beliefs and misinformation. This fact raises complications that any full account of the concept of rationality must address. The complications are side-stepped in the simpler account examined in this chapter.

4. There is usually a difference between a person's asking price—how much she would ask to part with something she already has—and her offering price—how much she would be willing to pay for that same thing if she did not already have it. Posner suggests that both prices must be used in determining something's value to a person, under his wealth maximization standard. In practice, though, he seems to rely mostly on the offering price.

5. The kind of legal right involved here is one that implies a duty on the part of others not to interfere with the activity protected by the right.

6. The hypothesis that social morality explains the common law does not by itself entail that each and every aspect of social morality is reflected in the common law's rules and doctrines. One could expect, for example, that practical considerations would demand rules that in some way depart from social morality. Thus, morality says that even gratuitous promises should be kept, but practical considerations may well reflect efficiency-related concerns about how society's resources are used, but they would serve to qualify and modify at the edges legal rules and doc-

7. Some recent philosophies of science have suggested that there are no "brute facts" with which to confront scientific hypotheses. These skeptical philosophies assert that everything—every occurrence, every situation—is a matter of interpretation, and there are no objective limits that can be placed on interpretation. Virtually all advocates of law and economics quite correctly reject these skeptical philosophies of science. It may well be true that there are no brute facts in the sense of facts that any person is logically compelled to accept, regardless of what else she believes. But there certainly are facts that no reasonable person can deny. It is simply not reasonable to deny that litmus paper turns red when placed in vinegar, that the weight of a given amount of mercury prior to combustion is less than the combined weight of the ash and remaining mercury after combustion, and that Halley's comet has a period of seventy-six years. And facts of this kind give science the leverage it needs to confront its hypotheses with the world.

Moreover, there is a crucial difference between systems of thinking that are self-correcting. The former do not in the least attempt to confront their ideas with the facts: quite the contrary, they attempt to shut out any facts inconsistent with their ideas. Stalinism (Soviet communism) is a good example of such a system of thought. It suppressed "inconvenient" facts that showed its ideas were mistaken. Any reasonable person can easily see the difference between the Stalinist suppression of facts and science's systematic testing of its hypotheses.

8. Following Bentham, many utilitarians are averse to any talk about moral, human, or natural rights. Mill is less hostile, but his account of rights still makes them derivative from social utility.