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**WEALTH, UTILITY,
AND THE HUMAN DIMENSION**

Jonathan Klick

Francesco Parisi*

Abstract

Functional law and economics, which draws its influence from the public choice school of economic thought, stands in stark contrast to both the Chicago and Yale schools of law and economics. While the Chicago school emphasizes the inherent efficiency of legal rules, and the Yale school views law as a solution to market failure and distributional inequality, functional law and economics recognizes the possibility for both market and legal failure. That is, while there are economic forces that lead to failures in the market, there are also structural forces that limit the law's ability to remedy those failures on an issue by issue basis. The functional approach then uses economic tools to analyze market and legal behavior in order to create meta-rules which limit the extent of the failures in each realm. These meta-rules are designed to induce individuals to reveal their preferences in cases where collective choices are necessary and to internalize the effects of their actions generally. This mechanism design or functional approach to law and economics focuses on ex ante social welfare maximization, rejecting both the ex post corrective function of law assumed by the Yale school of thought and the naturally evolving efficient system view espoused by the Chicago School. This ex ante perspective on the law evokes many interesting parallels with the internalized moral code presented in the Judeo-Christian tradition.

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Introduction

During its relatively short history, the law and economics movement has developed three distinct schools of thought. The first two schools of thought, the Chicago or positive school and the Yale or normative school, developed almost concurrently. The positive school restricts itself to the descriptive study of the incentives produced by the legal system largely because its adherents believe that efficient legal rules evolve naturally. On the other hand, the normative school sees the law as a tool for remedying "failures" that arise in the market.¹

The functional school of law and economics, which developed subsequently, draws from public choice theory and the constitutional perspective of the Virginia school of economics to offer a third perspective that is neither fully positive nor fully normative. Recognizing that there are structural forces that can often impede the development of efficient legal rules, the functional school allows for the possibility of using insights from economics to remedy faulty legal rules at a meta level. However, unlike the Yale school, the functional school also recognizes that there are failures in the political market that make it unlikely that changes will be made on a principled basis. Also, it is difficult to identify all the ultimate consequences of corrective legal rules. This skepticism induces the functional school to focus on using economic theory to design legal meta-rules that lead to efficiency *ex ante*. Achieving this *ex ante* efficiency requires the design of legal institutions that induce individuals to internalize the effects of their private activities, as well as to induce them to reveal their true preferences in situations where collective decisions must be made.

In addition to these over-arching differences about the role of law and economics in the design of legal institutions, there are other methodological divides among the schools of thought. These differences roughly boil down to disagreements about how to define efficiency on the individual decision level and in the aggregate. Specifically, the schools differ on how social preferences should be evaluated and what exactly should be maximized to achieve an optimal legal system.

In the sections that follow, we lay out the development of these schools of thought, detailing where they differ methodologically. We then discuss how the *ex ante* efficiency goal of the functional school parallels the moral framework found in the Judeo-Christian tradition.

I. Pursuing Well-Being: Methodological Problems in Law and Economics

Most practitioners of law and economics believe that there is an important common ground that unifies all scholars in the discipline, regardless of their ideological creed: a search for new insights into the law by applying economic concepts and

¹ See Francesco Parisi, *Positive, Normative and Functional Schools in Law and Economics*, 18 EUR. J. L. & ECON. 259, 264-66 (2004) (describing evolution of three schools and their ideological approaches).

theories.² Despite this common statement of purpose, various schools of law and economics can be identified, each with an elaborate research program and a distinct methodological approach.

A. Positive versus Normative Approaches to Law and Economics

During the early period of the discipline, law and economics scholarship was labeled as Chicago-style or Yale-style. These labels made reference to the respective dominant positive or normative approach utilized by each school.³ The origins of the Chicago and Yale schools of law and economics are attributable to the early work of a handful of scholars, including the pioneering work of Ronald Coase and Guido Calabresi in the early 1960s.

A difference in approach is detectable between the law and economics scholarship of the early 1960s, and that of the 1970s. The earlier studies appraised the effects of legal rules on the normal functioning of the economic system. By contrast, the subsequent generation of studies used economic analysis to achieve a better understanding of the legal system. Indeed, in the 1970s, a number of important applications of economics to law gradually exposed the economic structure of basically every aspect of a legal system: from its origin and evolution to its substantive, procedural, and constitutional rules.

In many respects, the impact of law and economics has exceeded its planned ambitions. One effect of the incorporation of economics into the study of law was to transform traditional legal methodology irreversibly. Legal rules began to be studied as an organic system. Economics provided the analytical rigor necessary for the study of the vast body of rules present in a modern legal system. This intellectual revolution came at an appropriate time, when legal academia was actively searching for a tool that permitted critical appraisal of the law, rather than merely strengthening the dogmatic consistencies of the system.

At this point, methodological differences came to surface with substantive practical differences. The Chicago school laid most of its foundations on the work carried out by Richard Posner in the 1970s. An important premise of the Chicago approach to law and economics is the idea that the common law is the result of an effort, conscious or not, to induce efficient outcomes. This premise is known as the efficiency of the common law hypothesis. According to this hypothesis, first intimated by Coase,⁴

² See Ejan MacKaay, *History of Law and Economics*, in 1 ENCYCLOPEDIA OF LAW AND ECONOMICS 66 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).

³ Despite some notable antecedents, it was not until the mid-twentieth century, through the work of Henry Simon, Aaron Director, Henry Manne, George Stigler, Armen Alchian, Gordon Tullock, and others, that the links between law and economics became an object of serious academic pursuit.

⁴ R. H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1, 2 (1960).

and later systematized and greatly extended by Posner, common law rules attempt to allocate resources in either a Pareto or Kaldor-Hicks efficient manner.⁵

Posner endorses a scientific approach that uses economics to study the legal system and the behavior it regulates objectively. He believes that positive economic analysis is immune to most abuse and misuse because it is merely used to explain or predict what incentives guide individuals and institutions under alternative legal rules.

The primary hypothesis advanced by positive economic analysis of law is the notion that efficiency is the predominant factor shaping the rules, procedures, and institutions of the common law. Posner contends that efficiency is a defensible criterion in the context of judicial decision-making because "justice" considerations, on the content of which there is no academic or political consensus, introduce unacceptable ambiguity into the judicial process. In arguing for positive use of economics, Posner is not denying the existence of valuable normative law and economics applications. In fact, law and economics often has many objective things to say that will affect one's normative analysis of a policy.⁶

Despite the powerful analytical reach of economic analysis, Chicago scholars acknowledged from the outset that the economist's competence in the evaluation of legal issues was limited. While the economist's perspective could prove crucial for the positive analysis of the efficiency of alternative legal rules and the study of the effects of alternative rules on the distribution of wealth and income, Chicago-style economists generally recognized the limits of their role in providing normative prescriptions for social change or legal reform.⁷

⁵ Further, common law rules are said to enjoy a comparative advantage over legislation in fulfilling this task because of the evolutionary selection of common law rules through adjudication. Several important contributions provide the foundations for this claim; the scholars who have advanced theories in support of the hypothesis are, however, often in disagreement as to its conceptual basis.

⁶ Posner offers crime as an example. Positive law and economics can help explain and predict how various punishments will affect the behavior of criminals. It might determine that a certain sanction is more likely to deter a certain crime. While this analysis does not by itself mean that the law should be adopted, it can be used to influence normative analysis on whether the law would be beneficial to society.

⁷ Recognition of the positive nature of the economic analysis of law was not sufficient to dispel the many misunderstandings and controversies in legal academia engendered by the law and economics movement's methodological revolution. As Coase indicated, the cohesiveness of economic techniques makes it possible for economics to move successfully into another field, such as law, and dominate it intellectually. R. H. Coase, *Economics and Contiguous Disciplines*, 7 J. LEGAL STUD. 201, 207-08 (1978). But methodological differences played an important part in the uneasy marriage between law and economics. The Popperian methodology of positive science was in many respects at odds with the existing paradigms of legal analysis. Rowley characterizes such differences, observing that positive economics follows the Popperian approach, whereby testable hypotheses (or models) are derived by means of logical deduction, then tested empirically. Charles K. Rowley, *Social Sciences and Law: The Relevance of Economic Theories*, 1 OXFORD J. LEGAL STUD. 391, 393-95 (1981). Anglo-American legal analysis, on the other hand, is generally inductive: lawyers use individual judgments to construct a general premise of law. Much work has been done in law and economics despite these methodological differences, with a reciprocal enrichment of the analytical tools of both disciplines.

To the contrary, the Yale school of law and economics, often described as the “normative” school, believes that there is a larger need for legal intervention in order to correct for pervasive forms of market failure.⁸ Distributional concerns are central to the Yale-style literature. The overall philosophy of this group is often presented as more value-tainted and more prone to policy intervention than the Chicago law and economics school.

Unlike its Chicago counterpart, this school has attracted liberal practitioners who employ the methodology of the Chicago school, but push it to formulate normative propositions on what the law ought to be like.⁹ Given the overriding need to pursue justice and fairness in distribution through the legal system, most Yale-style scholars would suggest that efficiency, as defined by the Chicago school, could never be the ultimate end of a legal system.

B. The Functional Approach and the Return to a Human-Centered Economic Analysis

As the domain of law and economics expanded, its perspective on methodological issues has not stagnated.¹⁰ In the 1990s, a new generation of literature, developed at the interface of law, economics, and public choice theory, pushed the boundaries of economic analysis of law, studying the origins and formative mechanisms of legal rules. The resulting approach, which we describe as the “functional” approach to legal analysis, is quite skeptical of both the normative and the positive alternatives.¹¹ The systematic incorporation of public choice theory into the economic approach to law may serve to bridge the conflicting normative perspectives in law and economics, at least by bringing the debate onto the more solid ground of collective choice theory.

⁸ See MacKaay, *supra* note 2, at 77–78. MacKaay observes that the Yale school considers market failures to be more pervasive than Chicago scholars are willing to admit. Legal intervention is believed to be the appropriate way of correcting such failures, although it may not succeed in all circumstances.

⁹ *Id.* at 75. Posner acknowledges that normative economic analysis, i.e., the use of economics to argue for what law should be, is susceptible to criticism. On the other hand, he notes that while economic analysis assesses the costs and benefits of a proposed rule, it is the non-economic weighting of the economic factors which is vulnerable to subjective ideology. Richard A. Posner, *Some Uses and Abuses of Economics in Law*, 46 U. CHI. L. REV. 281, 286–87 (1979).

¹⁰ Some degree of controversy still surrounds several of the methodological, normative, and philosophical underpinnings of the economic approach to law, although most of the ideological differences tend to lose significance because their operational paradigms often lead to analogous results when applied to real cases. However, some scholars perceive that the current state of law and economics as comparable to the state of economics prior to the advent of public choice theory, insofar as an understanding of “political failures” was missing from the study of market failures. See, e.g., James M. Buchanan, *Good Economics – Bad Law*, 60 VA. L. REV. 483, 491–92 (1974); Charles K. Rowley, *The Common Law in Public Choice Perspective: A Theoretical and Institutional Critique*, 12 HAMLINE L. REV. 355, 370 (1989). Public choice may indeed inject a skeptical, and at times disruptive, perspective into the more elegant and simple framework of neoclassical economics, but this added element may well be necessary to understand a complex reality.

¹¹ See Richard Posner & Francesco Parisi, *Scuole e Tendenze nella Analisi Economica del Diritto*, in 147 BIBLIOTECA DELLA LIBERTÀ 3 (1998) (giving brief intellectual history of three approaches to law and economics).

The functional approach is wary of the generalized efficiency hypothesis espoused by the positive school. In this respect, the functionalists share some of the skepticism of the normative school. Nothing supports a generalized trust in the efficiency of the law in all areas of the law. Even more vocally, the functional school of law and economics is skeptical of a general efficiency hypothesis when applied to sources of the law other than common law (e.g., legislation or administrative regulations).

The functional approach is also critical of the normative extensions and *ad hoc* corrective policies often advocated by the normative school. Economic models are a simplified depiction of reality. Thus, functionalists think it is generally dangerous to use such tools to design corrective or interventionist policies. In this respect, the functionalists are aligned with the positive school in their criticism of the normative approach. According to both the positivists and the functionalists, normative economic analysis often risks overlooking the many unintended consequences of legal intervention.

Public choice theory provides strong methodological foundations for the functional school of law and economics. The findings of public choice theory, while supporting much of the traditional wisdom, pose several challenges to neoclassical law and economics. In spite of the sophisticated mathematical techniques of economic analysis, judges and policymakers in many situations still lack the expertise and methods for evaluating the efficiency of alternative legal rules.¹² Courts and policymakers should thus undertake a functional analysis. Such an analysis requires them to first inquire into the incentives underlying the legal or social structure that generated the legal rule, rather than directly attempting to weigh the costs and benefits of individual rules.¹³ In this way, the functionalist approach to law and economics can extend the domain of traditional law and economics inquiry to include both the study of the influence of market and non-market institutions (other than politics) on legal regimes, and the study of the comparative advantages of alternative sources of centralized or decentralized lawmaking in supplying efficient rules.

With this focus on the underlying legal and social structure, there is less of an impetus to micro-manage individual rules. Such micro-management is likely to suffer from the rent-seeking activities of interested parties.

¹² An important premise of the functional approach to law and economics is its reliance on methodological individualism. According to this paradigm of analysis, only individuals choose and act. See, e.g., James M. Buchanan, *The Domain of Constitutional Economics*, 1 CONSTITUTIONAL POLITICAL ECONOMY 3–6 (1990), as well as the various contributions of the Virginia school of political economy. The functional approach to law and economics is informed by an explicit recognition that whatever social reality we seek to explain at the aggregate level, ought to be understood as the result of the choices and actions of individual human beings who pursue their goals with an independently formed understanding of the reality that surrounds them. See VIKTOR J. VANBERG, RULES AND CHOICE IN ECONOMICS 1 (1994). Normative individualism further postulates that only the judgment of the single individuals can provide a relevant benchmark against which the merits of alternative rules can be evaluated.

¹³ See Robert D. Cooter, *Structural Adjudication and the New Law Merchant: A Model of Decentralized Law*, 14 INT'L REV. L. ECON. 215, 226–27 (1994) (introducing a similar idea of structural adjudication of norms).

II. The Dilemma of Preference Aggregation: Pareto, Bentham, and Rawls

The need to make comparative evaluations between different rules motivates much of law and economics. Consequently, the second methodological problem in law and economics concerns the choice of criteria for carrying out such comparative analysis. In practical terms, this problem concerns the method of aggregation of individual preferences into social preferences. This problem is not unique to law and economics. It is part of a much larger methodological debate in economic philosophy and welfare economics.

Already, in 1881, F.Y. Edgeworth stated the moral dilemma of social welfare analysis, observing that a moral calculus should proceed with a comparative evaluation of the happiness of one person with the happiness of another.¹⁴ Such comparison can no longer be shirked if there is to be any systematic morality at all. The problem obviously arises from the fact that economists do not have any reliable method for measuring individuals' utility, let alone for making interpersonal comparisons of utility.

Economic analysis generally utilizes one of the three fundamental criteria of preference aggregation:

A. Ordinal Preferences and the Pareto Criterion

The first criterion of social welfare is largely attributable to Italian economist and sociologist Vilfredo Pareto. The Pareto criterion limits the inquiry to *ordinal* preferences of the relevant individuals. According to Pareto, an optimal allocation is one that maximizes the well-being of one individual relative to the well-being of other individuals being constant.¹⁵ In normal situations, there are several possible solutions that would qualify for such a criterion of social optimality. For example, if the social problem is that of distributing a benefit between two parties, any hypothetical distribution would be Pareto optimal, since there is no possible alternative redistribution that would make one party better off without harming another party.

The Pareto criterion has been criticized for two main reasons: (a) it is *status quo* dependent, in that different results are achieved depending on the choice of the initial allocation; and (b) it only allows *ordinal* evaluation of preferences, since it does not contain any mechanism to induce parties or decision makers to reveal or evaluate *cardinal* preferences (i.e., the intensity of preferences). As a result of these shortcomings, several scholars have questioned the usefulness of the Pareto criterion in its applications to law and economics.¹⁶

¹⁴ FRANCIS YSIDRO EDGEWORTH, *MATHEMATICAL PSYCHICS; AN ESSAY ON THE APPLICATION OF MATHEMATICS TO THE MORAL SCIENCES* 7-8 (1961).

¹⁵ As a corollary, a change to a Pareto superior alternative makes someone better off without making anyone worse off.

¹⁶ See Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 *YALE L.J.* 1211, 1212-14 (1991).

B. Utilitarian Tests: Bentham and Kaldor-Hicks

In the nineteenth and early twentieth centuries, economists and philosophers developed welfare paradigms according to what degree all affected individuals had to be taken into account in any comparative evaluation of different states of the world. This methodological trend, related to utilitarian philosophy, is best represented by philosophers and jurists such as Jeremy Bentham and later economists such as Nicholas Kaldor and J.R. Hicks, who in different ways formulated criteria of social welfare that accounted for the *cardinal* preferences of individuals.¹⁷

In *Principles of Morals and Legislation*, Bentham (1789) presents his theory of value and motivation. He suggests that mankind is governed by two masters: 'pain' and 'pleasure'. The two provide the fundamental motivation for human action. Bentham notes that not all individuals derive pleasure from the same objects or activities, and not all human sensibilities are the same.¹⁸ Bentham's moral imperative, which has greatly influenced the methodological debate in law and economics, is that policymakers have an obligation to select rules that give the greatest happiness to the greatest number. As pointed out by Paul Kelly, this formulation is quite problematic, since it identifies two maximands (i.e., degree of pleasure and number of individuals) without specifying the tradeoff between one and the other.¹⁹ Bentham's utilitarian approach is thus, at best, merely inspirational for policy purposes.

Later economists, including Kaldor, Hicks, and Tibor Scitovsky, formulated more rigorous welfare paradigms, which avoided the theoretical ambiguities of Bentham's proposition.²⁰ However, these formulations presented a different set of difficulties in their implementation. The core idea of their approach is that state A is to be preferred to state B if those who gain from the move to A gain enough to compensate those who lose. The test is generally known as the Kaldor-Hicks test of potential compensation. It is one of "potential" compensation because the compensation of the losers is only hypothetical and does not actually need to take place.²¹ In practical terms, the Kaldor-Hicks criterion requires a comparison of the gains of one group and the losses of the other group. As long as the gainers gain more than the losers lose, the move is deemed efficient. Mathematically, both the Bentham and the Kaldor-Hicks versions of efficiency are carried out by comparing the aggregate payoffs of the various alternatives and selecting the option that maximizes such summation.

¹⁷ JEREMY BENTHAM, AN INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION (1789); Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 *ECON. J.* 549, 549-52 (1939); J.R. Hicks, *The Foundations of Welfare Economics*, 49 *ECON. J.* 696 (1939).

¹⁸ JEREMY BENTHAM, AN INTRODUCTION TO THE PRINCIPLES OF MORALS AND LEGISLATION (1789). See also Richard Posner, *Bentham's Influence on the Law and Economics Movement*, 51 *CURRENT LEGAL PROBS.* 425 (1998), for an interesting discussion on Bentham and his influence on the law and economics movement.

¹⁹ PAUL KELLY, *NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW* 158 (1998).

²⁰ Kaldor, *supra* note 17, at 550-52; Hicks, *supra* note 17, at 697-712; Tibor Scitovsky, *A Note on Welfare Propositions in Economics*, 9(1) *REV. OF ECON. STUD.* 77, 77-88 (1941).

²¹ One should note that if actual compensation were carried out, any test satisfying the Kaldor-Hicks criterion of efficiency would also satisfy the Pareto criterion.

C. Non-Linear Social Preferences: Nash and Rawls

Other paradigms of social welfare depart from the straight utilitarian approach, suggesting that social welfare maximization requires something more than the maximization of total payoffs for the various members of society. Societies are formed by a network of individual relations, and there are some important interpersonal effects that are part of individual utility functions. Additionally, human nature is characterized by diminishing marginal utility, which gives relevance to the distribution of benefits across members of the group.

Imagine two hypothetical regimes: (a) in which all members of society eat a meal a day; and (b) in which only a random one-half of the population gets to eat a double meal while the other unlucky half remains starving. From a Kaldor-Hicks perspective, the two alternatives are not distinguishable from the point of view of efficiency because the total amount of food available remains unchanged. In a Kaldor-Hicks test, those who get a double meal have just enough to compensate the others, and thus society should remain indifferent between the two allocational systems. Obviously, this indifference proposition would leave most observers unsatisfied. In the absence of actual compensation, the criterion fails to consider the diminishing marginal benefit of a second meal and the increasing marginal pain of starvation. Likewise, the randomized distribution of meals fails to consider the inter-personal effects of unfair allocations. Fortunate individuals suffer a utility loss by knowing that other individuals are starving while they enjoy a double meal. Because of the diminishing marginal utility of wealth and interpersonal utility effects, from an *ex ante* point of view, no individual would choose allocation system (b), even though the expected return from (b) is equal to the return from (a).

Scholars that try to evaluate the welfare implications of distributional inequalities generally do so by invoking John Rawls' theories of justice²² or by using Nash's²³ framework of welfare.

²² See JOHN RAWLS, *A THEORY OF JUSTICE* (1971). Notable scholars have considered the conditions under which principles of justice can emerge spontaneously through the voluntary interaction and exchange of individual members of a group. As in a contractarian setting, the reality of customary law formation relies on a voluntary process through which members of a community develop rules that govern their social interaction by voluntarily adhering to emerging behavioral standards. See also John Harsanyi, *Cardinal Welfare, Individualistic Ethics, and Interpersonal Comparisons of Utility*, 63(4) J. POL. ECON. 309, 309-21 (1955). In this setting, Harsanyi suggests that optimal social norms are those that would emerge through the interaction of individual actors in a social setting with impersonal preferences. The impersonality requirement for individual preferences is satisfied if the decision makers have an equal chance of finding themselves in any one of the initial social positions, and they rationally choose a set of rules to maximize their expected welfare. Rawls employs Harsanyi's model of stochastic ignorance in his theory of justice. However, the Rawlsian "veil of ignorance" introduces an element of risk aversion in the choice between alternative states of the world, thus altering the outcome achievable under Harsanyi's original model, with a bias toward equal distribution (i.e., with results that approximate the Nash criterion of social welfare). For further analysis of the spontaneous formation of norms and principles of morality, see generally Amartya Sen, *Rational Fools: A Critique of the Behavioural Foundations of Economic Theory*, in *PHILOSOPHY AND ECONOMIC THEORY* 87-109 (Frank Hahn & Martin Hollis

The intuition underlying these criteria of welfare is relatively straightforward: the well-being of a society is judged according to the well-being of its weakest members. The use of an algebraic product to aggregate individual preferences captures that intuition. Like the strength of a chain is determined by the strength of its weakest link, so the chain of products in an algebraic multiplication is heavily affected by the smallest multipliers. Indeed, at the limit, if there is a zero in the chain of products, the entire grand total will collapse to zero. This means that the entire social welfare of a group approaches zero as the utility of one of its members goes to zero.

In the law and economics tradition, these models of social welfare have not enjoyed great popularity. This is not so much for an ideological preconception, but rather for a combination of several practical reasons. These reasons include the general tendency to undertake a two-step optimization in the design of policies and the difficulties of identifying an objective criterion for assessing interpersonal utility and diminishing marginal utility effects. From a methodological point of view, distributional concerns are generally kept separate from the pursuit of efficiency in policymaking. Such separation has been rationalized on the basis that the legal system is too costly an instrument for distribution, given the advantage of the tax system for wholesale reallocation of wealth.²⁴

Some of the tension among these three social welfare standards is dissipated by the functional school's focus on *ex ante* welfare. That is, ideally, legal meta-rules should be designed to maximize expected welfare, not realized welfare. From the *ex ante* perspective, there is no tension between the Pareto and the Hicks-Kaldor standard. Further, while the *ex ante* perspective does not require the generalized risk aversion posited in the Rawlsian veil of ignorance decision rule, it does allow for the protection of the "worst-off" member of society along dimensions where a representative individual would rationally choose such protections *ex ante*. This notion is implicit in the Buchanan and Tullock derivation of optimal constitutional rules, which serves as part of the foundation of functional law and economics.²⁵

III. Wealth, Utility, and the Human Dimension

There is a third methodological problem. What should the legal system try to maximize? In this debate, even strict adherents to the instrumentalist view of the law

eds., 1979); EDNA ULLMANN-MARGALIT, *THE EMERGENCE OF NORMS* (1977); DAVID GAUTHIER, *MORALS BY AGREEMENT* (1986).

²³ See John Nash, *The Bargaining Problem*, 18(2) *ECONOMETRICA* 155, 155-62 (1950). According to the Nash criterion, social welfare is given by the product of the utility of the members of society. See also DENNIS MUELLER, *PUBLIC CHOICE II* 379-82 (1989). Mueller attributes the multiplicative form of the social welfare function to Nash.

²⁴ See Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 *J. LEGAL STUD.* 667, 667-81 (1994).

²⁵ JAMES BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY* (1962).

may question whether the objective of the law should be the maximization of aggregate wealth or the maximization of aggregate utility.

If the scholars involved in this debate could look at the issue as neutral spectators, consensus could likely be reached on the idea that the ultimate policy goal is the maximization of human happiness and well-being. Consequently, the human dimension cannot be bypassed in policy evaluation. But regardless of such an observation, economic analysis of law rarely uses utility-based methods of evaluation. The reason for this is, once again, mostly pragmatic. Unlike wealth (or quantities of physical resources), utility cannot be objectively measured. Furthermore, interpersonal comparisons of utility are impossible, rendering any balancing across groups or individuals largely arbitrary. These limitations make utility maximization unviable for practical policy purposes.

Given the above limitations, practitioners of the economic analysis of law have departed from the nineteenth century utilitarian ideal of utility maximization.²⁶ Rather, they have increasingly used a paradigm of wealth maximization. Posner is the most notable exponent of the wealth maximization paradigm. Under wealth maximization principles, a transaction is desirable if it increases the sum of wealth for the relevant parties (where wealth is meant to include all tangible and intangible goods and services).

The early years of law and economics were characterized by some uneasiness in accepting the notion of wealth maximization as an ancillary paradigm of justice. Although most of the differences proved to be largely verbal, and many others were dispelled by the gradual acceptance of a distinction between paradigms of utility maximization and wealth maximization, two objections continue to affect the lines of the debate.

The first objection relates to the need for specifying an initial set of individual entitlements or rights as a necessary prerequisite for operationalizing wealth maximization. In this context, one can think of the various criticisms of wealth maximization by property rights advocates who perceive the social cost of adopting such criterion of adjudication as very high, given wealth maximization's instrumentalist view of individual rights and entitlements. These critics argue that rights have value that must be accounted for, regardless of how useful they might be to the accumulation of wealth. Along similar lines, these critics suggest that the wealth maximization criterion of economic analysis is comparable to the methodological approach of economics prior to the

²⁶ Bentham challenged the use of objective factors, such as wealth or physical resources, as a proxy for human happiness. Despite the difficulties in quantification of values such as utility or happiness, the pursuit of pleasure and happiness and the avoidance of pain are the motivating forces of human behavior. Wealth, food, and shelter are mere instruments to achieve such human goals.

advent of public choice theory, insofar as an understanding of “political failures” was missing from the study of collective decision-making.²⁷

The second objection springs from the theoretical difficulty of defining the proper role of efficiency as an ingredient of justice, vis-à-vis other social goals. Legal scholars within the law and economics tradition have claimed that an increase in wealth cannot constitute social improvement unless it furthers some other social goal, such as utility or equality.²⁸ Denying that one can trade off efficiency against justice, these scholars argue instead that efficiency and distribution are equally essential elements of justice, which is seen as a goal of a different order than either of its constitutive elements.

In several of his writings, Posner stands as the most notable defender of the criterion of wealth maximization, addressing these important questions and justifying wealth maximization as a worthy standard for evaluating legal rules. Posner explicitly advocates wealth maximization as a criterion that should guide judicial rule-making. In order to make the case for wealth maximization, he defines it and compares it with the alternative theories of utilitarianism and libertarianism. As mentioned earlier, wealth maximization occurs when a transaction increases the total amount of goods and services, weighted by offer prices and demand prices.²⁹ Because of the market’s ability to capture subjective values and preferences, wealth maximization is a comprehensive measure of social welfare.³⁰

A. Utilitarianism, Libertarianism, and Efficiency

Much of the criticism of law and economics lies in the mistaken belief that wealth maximization is a form of utilitarianism. Prior to his important article on utilitarianism and legal theory, Posner himself had been wrongly characterized as acknowledging utilitarianism as the inspiration of law and economics. Posner distinguishes utilitarianism from the methodological premises of law and economics, arguing in favor of wealth maximization as a superior normative theory of law.³¹

²⁷ Buchanan, *supra* note 10, at 483-92; Rowley, *supra* note 10, at 355-83.

²⁸ See Guido Calabresi, *About Law and Economics: A Letter to Ronald Dworkin*, 8 HOFSTRA L. REV. 553, 553-62 (1980).

²⁹ For intangible goods for which there are no explicit markets, Posner suggests that shadow prices serve equally well as tools of objective evaluation.

³⁰ In a methodological comparison of the various criteria of social choice, Posner considers the value of wealth maximization as a criterion for guiding judicial rule making and adjudication. Even if no moral or ethical argument can be established in its favor, wealth maximization or efficiency is still a valuable tool for normative analysis. Richard Posner, *The Justice of Economics*, 1 ECONOMIA DELLE SCELTE PUBBLICHE 115 (1987). Posner further points that economics can, with a morally neutral approach, provide an evaluation of the costs of any proposed action. Economics can provide direction to any decision, particularly one in which efficiency is a prevailing value. Richard Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103 (1979); Richard Posner, *Law & Economics Is Moral*, 24 VAL. U. L. REV. 163 (1990).

³¹ Richard Posner, *The Justice of Economics*, 1987 J. PUB. FIN. & PUB. CHOICE 15 (1987).

According to Posner, utilitarianism holds that the worth of a law should be judged by its effect in promoting the surplus of pleasure over pain across society. Normative economics holds that a law should be judged by its effects in promoting social welfare, a term which when broadly defined almost means the same as utilitarian happiness. In this context, Posner suggests that economists' use of "utility" as a synonym for "welfare" adds to the confusion.

Utilitarianism is distinct from wealth maximization because it seeks to maximize aggregate "happiness," while wealth maximization seeks to maximize aggregate economic utility, called "wealth." While happiness is a philosophical concept that cannot be easily measured, wealth is more practical and measurable.³² More fundamentally, happiness is an insufficient social goal because happiness is passive and focuses on consumption. Wealth maximization, on the other hand, is dependent on productive effort. While aware of the limits of a concept of wealth as a good in itself, Posner believes that wealth maximization results in a work ethic that is in fact necessary for utilitarian happiness to be brought about and thus is an important mechanism for the advancement of society. While not precluding an instrumentalist maximization of wealth, Posner's theory does not rely on utilitarianism as a necessary methodological assumption.³³

There is a possible intuitive justification for wealth maximization. This intuitive foundation was first emphasized by Richard Posner, who argued that wealth maximization can be regarded as a superior ethical principle because it is more consistent with ethical intuitions, provides for a more sound theory of justice, and yields more definite results than the alternative economic views on justice.³⁴ By promoting the efficient use of resources, wealth maximization encourages traditional capacities, such as intelligence, and traditional virtues, such as honesty.³⁵

³² Posner *Utilitarianism*, *supra* note 30; Posner *The Justice of Economics*, *supra* note 30.

³³ To evaluate the ethical argument for efficiency rather than utilitarianism, Posner acts on the presumption that any ethical theory is valid unless rejected, and he evaluates both utilitarianism and wealth maximization on two principal grounds for rejecting an ethical theory: its logical inadequacy or its incongruence with widely shared ethical intuitions. Posner regards utilitarianism as somewhat illogical and inconsistent with generally-accepted notions of individual rights. Its logical and moral shortcoming rests in its boundless insistence that we maximize the total amount of happiness in the universe, even beyond human utility, which can only be attained by making many people unhappy. In this way, Posner attacks traditional utilitarianism for its indefiniteness. Posner *Utilitarianism*, *supra* note 30.

³⁴ *Id.*

³⁵ *Id.* Posner suggests that wealth maximization also supports the creation of a system of exclusive rights that extends to all valued things that are scarce, with the initial right vesting in those who are likely to value them the most and a free market for those rights once assigned (resembling Adam Smith's system of "natural liberty"). It relies on traditional capacities and virtues to reduce the cost of transacting those rights. Further, wealth maximization requires legal rules to promote hypothetical bargains where transaction costs are prohibitive. It also requires legal remedies to deter and redress the invasion of rights. Thus, a market economy regulated according to wealth-maximizing principles fosters empathy and benevolence without destroying individuality.

An important part of the debate on the paradigm of wealth maximization relates to its ethical and normative justification. This foundational work in law and economics has been described as a form of normative analysis that “turns the mirror of analysis inward,” attempting to answer the fundamental question of “why the law or public policy should promote efficiency.”³⁶ Advocates of wealth maximization generally offer two basic arguments in support of such a normative goal: a teleological justification and a consent justification. These justifications have come under the scrutiny of well-known legal and economic theorists.

According to Coleman, wealth maximization is a form of Kaldor-Hicks maximization under disguise.³⁷ The practical advantages of wealth-maximization over utility-maximization relate to the fact that it is easier to ascertain actual changes in wealth as opposed to utility. In spite of such practical superiority, Posner’s normative criterion remains subject to several of the shortcomings of the Kaldor-Hicks criterion, including its difficult moral defensibility. Posner’s defense of wealth maximization has been further criticized for building upon notions of implied, rather than actual, consent. Coleman recognizes the usefulness of tests of hypothetical consent, à la Rawls, but questions the uniqueness of wealth maximization as a dominant criterion of justice from the perspective of *ex ante* social choice.³⁸ The indeterminacy of such hypothetical social choice poses a challenge to the consent-based moral justification of wealth maximization.

B. Efficiency, Morality, and Economic Theories of Justice

In spite of the articulate defense of the criterion of efficiency in legal and policy decisions, most law and economics scholars do not argue that efficiency concerns should replace morality. However, whenever moral or ethical theories of justice fail to generate unambiguous results that could guide policy choices and, more generally, in the absence of trumping moral or ethical concerns, efficiency provides the most appropriate criterion for allocating limited resources among competing claims.

Legal scholars (e.g., Malloy), however, have often argued that efficiency-based and utilitarian theories of justice promote “disrespect for individual liberty,” are “indeterminative and elitist,” and “can hardly be viewed as anything other than amoral, if not immoral.”³⁹ Posner, in his reply to Malloy, once again, takes issue. He suggests that these critiques miss the mark in that they treat the methodology of law and economics

³⁶ Jules Coleman, *The Normative Basis of Economic Analysis: A Critical Review of Richard Posner’s “The Economics of Justice,”* 34 STAN. L. REV. 1105, 1105-31 (1982). Libertarianism challenges the wholesale endorsement of wealth maximization because of the libertarian interest in personal autonomy over social welfare and its opposition to coercive exchanges, be they explicit or under disguise. Posner notes that when compensation is considered *ex ante*, much coercive exchange is essentially voluntary, thus satisfying libertarian concerns.

³⁷ *Id.* at 1112.

³⁸ *Id.*

³⁹ Robin Malloy, *The Merits of the Smithian Critique: A Final Word on Smith and Posner,* 36 U. KAN. L. REV. 267, 267-74 (1988).

as a political theory.⁴⁰ Indeed, Posner, while arguing that wealth maximization is the best normative and positive theory of common law rights and remedies, never suggested that wealth maximization should be the only social value or principle of justice.⁴¹

Even the most extreme advocates of wealth maximization do not contend that such criterion should override moral concerns. The preference for wealth maximization over other criteria of welfare derives from the general suspicion against paternalistic governmental intervention (which would unavoidably be triggered if morality were recognized as the sole criterion of legal interpretation and judicial action) and the risks involved in shifting the burden on the judiciary in asking judges to decide controversies on the basis of distributive considerations.

Wealth maximization sometimes runs contrary to moral guides such as natural rights. The natural rights perspective views society as a compact in which people surrender just enough of their own natural liberties as necessary to protect everyone else's equal natural liberties. Posner believes that because the notion of natural rights can be expanded so readily, it is too unstable a foundation to build upon. He also believes that it is fundamentally anti-democratic because it holds that the more rights people have, the smaller the permissible scope of public policy deliberation.⁴²

Many of the arguments made by natural rights proponents rely on examples for which there is moral consensus. Posner points out that the power of natural rights moral discourse runs out when one faces controversial moral issues. Thus, paradoxically, whenever an analytical perspective is most needed to frame policy questions, natural rights emerge as non-dispositive, and thus hardly valuable, instruments of adjudication.

Functional law and economics bypasses the wealth/utility divide by focusing on choice or revealed preference as the criterion of decision. That is, by designing mechanisms through which parties are induced to reveal their subjective preferences, the functional law and economics approach obviates the need for third parties, such as judges or legislators, to decide between wealth and utility as the appropriate maximand. The institutions favored by the functional approach minimize the impediments to the full revelation of the subjective preferences of the parties to a transaction by focusing on incentive compatibility mechanisms. This mechanism-design approach tends to align individual and social optimality.

⁴⁰ Richard Posner, *The Ethics of Wealth Maximization: Reply to Malloy*, 36 U. KAN. L. REV. 261, 261-65 (1988).

⁴¹ *Id.* at 261-65. Posner is libertarian in that he is suspicious of public intervention and favors small government. He uses economic theory to define what he sees as the appropriate role of the government: to intervene and correct serious market failures. He is pragmatic in the sense that he does not derive these free-market views from dogmatic or philosophical underpinnings. Instead, he uses wealth maximization to operationalize his economic libertarianism.

⁴² *Id.*

IV. The Human-Centered Approach of Functional Law and Economics

The *ex ante* efficiency perspective of the functional school of law and economics can in many ways be analogized to the human-centered functional perspective of the moral precepts of the Judeo-Christian tradition. Just as functional law and economics favors the “rule of law” over the “law of rules” in its focus on the structural origin of the law as opposed to its practical application, the foundation of the moral precepts of the Biblical tradition show this more general concern. This concern is illustrated quite clearly in Mark 2:23-28, in which the Pharisees questioned Jesus about his disciples’ choice to pluck grain on the Sabbath. Jesus replied, “The Sabbath was made for man, not man for the Sabbath.”⁴³ Similar proclamations are made in the story of Jesus curing the man with the withered hand on the Sabbath,⁴⁴ as well as in Jesus’ response to the question of why His disciples did not fast as John’s disciples and those of the Pharisees did.⁴⁵ However, the Biblical Jesus makes clear that he does not reject the structure of the law, as expressed forcefully in his discussion on the law and the prophets. Here the instrumental value of moral laws for the ultimate fulfillment of humanity’s highest aspirations is revealed by the text: “Think not that I have come to abolish the law and the prophets; I have come not to abolish them but to fulfill them.”⁴⁶

In many other contexts, the human-centered approach of functional law and economics uses instruments that are germane to some well-known precepts of Judeo-Christian ethics. The Biblical Golden Rule is an example of this approach. In spite of great variation of ethical values from one culture to another, norms of reciprocity stand as universal principles in virtually every human society, both historical and contemporary. No single principle or judgment is as widely and universally accepted as the reciprocity principle, in both its positive and negative versions. The relative importance of the positive and negative components of the reciprocity principle appears to depend on the state of advancement of society and administration of justice.

More notably, reciprocity norms first materialize in their negative form in lesser developed societies, while norms of positive reciprocity dominate in more developed societies. In early codes of the Babylonian and Biblical tradition, the reciprocity principle takes the first form as a principle of negative reciprocity or retaliation.⁴⁷ The talionic principle of “an eye for an eye, a tooth for a tooth,” is the most notable illustration of the early principles of negative reciprocity.⁴⁸ Similar incarnations of principles of retributive justice emerge in virtually every early legal system for the treatment of wrongdoing, both voluntary and involuntary.⁴⁹ These rules in turn represent a

⁴³ The same story is related in all of the synoptic Gospels.

⁴⁴ *Matthew* 12:9-14; *Mark* 3:1-6; *Luke* 6:6-11.

⁴⁵ *Matthew* 9:14-17; *Mark* 2:18-22; *Luke* 5:33-39; *John* 3: 29-30.

⁴⁶ *Matthew* 5:17-20.

⁴⁷ Early notions of punitive justice are embedded in the ancient practices of indiscriminate personal revenge. In this sense, Biblical scholars describe practices of retaliation as a form of “revenge traveling towards justice.” See Joel Blau, *Lex Talionis*, in YEARBOOK OF THE CENTRAL CONFERENCE OF AMERICAN RABBIS 4 (1916).

⁴⁸ *Exodus* 21:23-24; *Leviticus* 24:17-22.

⁴⁹ See Francesco Parisi, *The Genesis of Liability in Ancient Law*, 3 AM. L. & ECON. REV. 82 (2001).

broader concept of reciprocity, which was subsequently articulated as a positive mandate.⁵⁰ The command to “love thy neighbor as thyself” sums up the positive and prescriptive nature of the rule of positive reciprocity. Economists and behavioral scientists have devoted considerable attention to both positive and negative versions of reciprocity and revealed that negative reciprocity may be as important as honesty and positive reciprocity for the evolution of cooperation.⁵¹ Positive and negative reciprocity are complementary instruments that provide the best strategic attitudes in different sets of social interactions.

This leads us to suggest that there may be an important relationship between the establishment of norms of negative reciprocity and the subsequent positive corollaries. In evolutionary terms, positive reciprocity without a complementary attitude for negative reciprocity would not be sustainable. In both its negative and positive versions, the Biblical Golden Rule of treating others the way you wish to be treated embodies one of the fundamental precepts of the functional law and economics movement.⁵² That is, *ex ante* efficiency requires that an individual internalizes the effects of his actions.⁵³ By treating others the way you would have yourself treated, internalization necessarily occurs.⁵⁴ This golden rule mirrors the functional model of reciprocity provided in Fon and Parisi (2003).

In many other contexts, functional law and economics identifies principles that could govern human action, starting from the observation and recognition of the fundamental needs and shortcomings of human nature. Functional law and economics attempts to activate mechanisms that give greatest freedom to individual choice, guiding such choice by means of structural principle, rather than specific normative pre-

⁵⁰Matthew 7:12; Luke 6:31.

⁵¹Positive reciprocity and negative reciprocity have different domains of application. In the presence of cooperative first movers, positive reciprocation would provide an effective response, but in the face of an aggressive first mover, positive reciprocity would provide a quite inadequate response.

⁵²Levy and Peart present an argument that the Golden Rule is formally equivalent to the greatest satisfaction principle of utilitarianism. This is only true from the *ex ante* perspective taken by the functional law and economics school. That is, the Golden Rule only leads to utility maximization *ex ante*, but at any given time, it might be possible to increase current utility by deviating from the rule. This “time inconsistency” problem is remedied in the functional framework by the imposition of binding meta-rules that constrain individuals from deviating for their own short-term gain. This pre-commitment function of law occupies central importance in functional law and economics analysis. David M. Levy & Sandra J. Peart, *Who Are the Canters? Economists & Evangelicals in Coalition* (Dec. 30, 2002) (unpublished manuscript, on file with the NYU *Journal of Law & Liberty*).

⁵³Through this internalization, rule-making costs and subsequent monitoring costs are minimized. Delving into the sources of law to find their cost-minimizing basis is one of the hallmarks of the functional law and economics movement. For an empirical examination of the extent to which doctrines actually affect the behavior of Christians, see Jonathan Klick, *Salvation as a Selective Incentive: An Olsonian Analysis of the Faith vs. Works Cleavage* (Feb. 2002) (George Mason Law & Economics Research Paper No. 02-14, on file with the NYU *Journal of Law & Liberty*). In that article, Klick shows how differences among the various Christian denominations about what is required for salvation generates significant differences in donation practices. Specifically, since the benefits of church contributions are internalized through salvation for Catholics, there is significantly less free-riding among older Catholics relative to older non-Catholic Christians.

⁵⁴A similar message is contained in *Matthew 22:39; Mark 12:31; Luke 10:27*.

scriptions, to induce individuals to act as if they were internalizing the direct consequences of their actions, such as when acting under reciprocity constrains in the above illustrations.

Other illustrations of functional principles of law and economics include the following: mechanism design to induce incentive alignment, preference revelation mechanism for subjective value, and freedom of contract and parties' autonomy in private contracting. We shall briefly illustrate these principles drawing some analogies with other well-known parables of the Biblical tradition.

The mechanism design perspective of economics attempts to channel the intrinsic behavioral tendencies of individuals to reach a desired social outcome. That is, rather than attempt to alter individual behavior, functional law and economics suggests that institutions should provide incentives such that individuals will naturally act in a desired way without any external monitoring or coercion. This necessarily requires that individuals have the ability and incentive to reveal their own subjective values and preferences, and that all costs and benefits generated by an individual's actions accrue to that individual. This implies that individuals will only achieve socially optimal outcomes when they act for their own gain, and incentives are not attenuated by principal agent problems whereby an individual is directed to fulfill some social goal directly. This notion also permeates the Biblical message: "No one can serve two masters; for either he will hate the one and love the other, or he will be devoted to one and despise the other."⁵⁵ A similar sentiment is declared in the proclamation that "Every kingdom divided against itself is laid waste, and no city or house divided against itself will stand."⁵⁶

This individual-centered focus also solves another seemingly intractable problem encountered in a corporate approach to law. Utility maximization necessarily requires that subjective values be attributed to human action. However, it is not possible for an outside observer to evaluate these subjective values and draw the appropriate legal or policy conclusions to maximize social welfare. To avoid this information problem, the functional law and economics approach relies on institutions that provide individuals with the opportunity to express their own values truthfully. These revealed preferences are then granted complete validity in normative terms with law and policy makers taking them as a given.

Along these subjective value lines, there is a great deal of economic intuition in many of the parables contained in the passages of the New Testament. This intuition reflects the great power of the methodological individualism paradigm in explaining human behavior. Although the Bible is replete with examples of this, we focus on two illustrations drawn from the New Testament. In the so-called story of the widow's mite, Jesus embraces a subjective theory of value. "He looked up and saw the rich put-

⁵⁵Matthew 6:24; also found in Luke 16:13.

⁵⁶Matthew 12:25; Mark 3:24-25; Luke 11:17.

ting their gifts into the treasury; and he saw a poor widow put in two copper coins. And he said, "Truly I tell you, this poor widow has put in more than all of them for they all contributed out of their abundance, but she out of her poverty put in all the living that she had."⁵⁷ This respect of subjective value flows also to the functional law and economics treatment of exchange between parties. Instead of evaluating the "fairness" or "justice" of individual transactions, the functional approach respects individuals' freedom of contract, taking the fact that individuals agree to an arrangement as evidence of the transaction's intrinsic value for the parties. The same sentiment is expressed in the parable about the laborers in the vineyard, in which the various workers are paid an effectively differential wage since all receive the same nominal wage but some worked longer than others. Rather than see this as unjust, Jesus has the vineyard owner reply to the disgruntled workers in the following way: "Friend, I am doing you no wrong; did you not agree with me for a denarius?"⁵⁸

The parallels between the teachings of Judeo-Christian ethics and the insights of functional law and economics are striking. Indeed, functional law and economics analysis exposes the internal consistency of many normative religious teachings that would otherwise appear to be at odds with each other.

V. Conclusion

Functional law and economics avoids paternalism and methodological imperialism by formulating value-neutral principles of collective choice. Functional law and economics builds upon the methodological premises of normative individualism, giving greatest freedom to individual choice, and fostering socially desirable human action by establishing structural principles to induce individuals to take into account private information and subjective values and truthfully reflect such information and values in their behavioral choices. Functional law and economics represents a mode of analysis that bridges and, in some sense, improves upon both the Chicago and Yale schools of thought in law and economics. Through its *ex ante* perspective, the functional school focuses on mechanism design issues to explain the origins of law, capturing both the efficiency and non-efficiency perspectives of the other two schools. Functional law and economics provides a framework to understand not only the development of formal legal systems but also ethical and moral codes.

⁵⁷Luke 12:1-4; also found in Mark 12:41-44.

⁵⁸Matthew 20:1-16.