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Miscalculating Welfare

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Miscalculating Welfare

Baby-selling.[1] Racial discrimination.[2] Insider trading.[3] Legal economists have argued that each of these activities should be legalized in the service of wealth maximization. Indeed, these are just a few of the legions of contrarian proposals advanced by legal economists as efficient. Such proposals are at least counterintuitive, and perhaps even shocking. In fact, from a careerist perspective, their startling quality may be their primary virtue. But in pursuing the attention that comes with novelty, the authors of these works have overlooked the negative externalities that also accompany avant-garde positions. Legal rules that strike most people as unjust may upset community expectations and undermine the efficiency of the very rules proposed. In short, such rules may not prove wealth-maximizing at all.

Counterintuitive rules are even less likely to prove *welfare* maximizing. The proclaimed goal of economics is to find welfare-maximizing policies. Because of the difficulties associated with measuring welfare, many economists – and the vast majority of legal economists – focus instead on wealth maximization, under the generally implicit assumption that social welfare rises monotonically with social wealth. This assumption is badly flawed. People often express a willingness to trade some material wealth in exchange for intangible values such as justice, fairness, or even predictability. Unjust seeming rules, then, are even more unlikely to maximize social welfare than they are to enhance social wealth. To truly enhance social welfare, economists should examine more closely the relationship between wealth, social values, and welfare.

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[1] Elisabeth M. Landes & Richard A. Posner, *The Economics of the Baby Shortage*, 7 J. LEGAL STUD. 323 (1978).

[2] RICHARD EPSTEIN, FORBIDDEN GROUNDS: THE CASE AGAINST EMPLOYMENT DISCRIMINATION LAWS (1992).

[3] Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983).

In this essay, we argue that legal economists' failure to include people's preferences for fairness undermines their policy prescriptions, even by economists' own maximizing standards. Part I discusses three prominent counterintuitive proposals from legal economists. Our purpose here is not to engage the authors' arguments in detail, but rather to provide a context for the rest of our discussion. Part II first argues that the proper focus of law and economics is welfare and not wealth, and legal economists should not assume welfare is enhanced whenever wealth is maximized. Part II then turns to the people's preferences for fair rules. Here, we discuss the empirical evidence of people's preferences for fair rules, and argue that given this evidence, it is methodologically unacceptable for legal economists to fail to include (and to give sufficient weight to) these preferences within their calculations. Part III discusses the likely costs of actually adopting rules that are broadly perceived as surprising and unfair. We point out that such rules are likely to defeat reasonable expectations, instigate resistance, and undermine the overall legitimacy of the legal system. As a result, we believe these proposals fail even on their own wealth-maximizing terms. Part IV discusses the market hidden behind this discussion – the market for this sort of creative, but counterintuitive, legal scholarship. Here, we discuss the positive and negative effects of lending legitimacy to and rewarding these sorts of counterintuitive proposals.

I. A Few Salient Examples

The Law and Economics literature is rife with examples of proposals that would strike most non-economists as unfair, immoral, or at least unexpected. In this section, we highlight a few prominent examples to concretize the phenomena and ground our subsequent discussion. In a way, this section was the most difficult for us to write, not because we had difficulty finding suitable examples but because we found so very many. Nevertheless, we have managed to limit our textual discussion to three.[4]

A. Baby Selling

Richard Posner is generally considered the most prominent legal economist alive today. In 1978 he and coauthor Elisabeth Landes proposed that baby selling (their term not ours) be legalized.[5] Despite the shocking terminology, the authors' intentions were manifestly benign. They argued that creating an open and legal market permitting an adoptive parent to pay a natural mother for the right to adopt her child would have numerous positive effects. Paying mothers for their children would reduce the number of abortions, eliminate the shortage of babies available for adoption, and decrease the number of unadopted children kept in foster care.[6] Their article employed sophisticated mathematical modeling and statistical data to bolster their argument that legalizing baby sales would produce these beneficent policy outcomes.

Posner and Landes acknowledged that many people would consider a market in children "undesirable."[7] They cited commentators who referred to such a market as "dealings in human flesh" and a "taint on civilized society."[8] They also admitted that permitting natural parents to sell their children might "smack of slavery"[9] and produce

[4] For interested readers, we note here some other promising candidates. Thomas J. Miceli & Kathleen Segerson, *Punishing the Innocent Along with the Guilty: The Economics of Individual versus Group Punishment*, 36 J. LEGAL STUD. 81 (2007) (group punishment); James D. Miller, *Using Lotteries to Expand the Range of Litigation Settlements*, 26 J. LEGAL STUD. 69 (1997) (settling disputes by lottery); Moin A. Yahya, *Deterring Roper's Juveniles: Using a Law and Economics Approach to Show that the Logic of Roper Implies that Juveniles Require the Death Penalty More than Adults*, 111 PENN. ST. L. REV. 53 (2006) (executing minors).

[5] Landes and Posner, *supra* note 1.
[6] *Id.* at 325, 327.
[7] *Id.* at 339.
[8] *Id.*
[9] *Id.* at 344.

"moral outrage."[10] But they argued that these objections were not well-founded. Unlike slaves, children sold through their system would retain the protections of legal prohibitions on child abuse and neglect, though these protections might admittedly prove inadequate.[11] Also, while a market system would not screen parents for suitability the way the current system does, they doubted the value of such screening and proposed requiring some "minimal background investigation" for buyers in the baby market, a sort of driver's license for baby purchasers.[12] Landes and Posner took comfort in their faith that people do not generally buy expensive items in order to damage them, analogizing adoption of a child to the purchase of a television set.[13]

Perhaps their most telling point is their analysis of the likely costs of babies in the newly legalized market. Although the black market for babies resulted in very high prices, they argued that in a legal market babies would be relatively affordable.[14] They had several supportive arguments, but the most interesting for our purposes involved the amount necessary to compensate the natural mother for giving up her baby rather than aborting the pregnancy or raising the child herself. Landes and Posner contended that the *net* cost in this category would be quite low because the costs to the natural mother would be substantially identical to those saved by the adoptive mother in not bearing a child herself.[15] While this theory might have some validity when applied to medical costs,[16] we think most mothers would find quite surprising the proposition that the amount they

[10] *Id.* at 345.
[11] *Id.* at 343.
[12] *Id.*
[13] *Id.*
[14] *Id.* at 339-41.
[15] *Id.* at 340.
[16] Even when applied to medical costs, we actually doubt the theory's validity. Presumably, mothers giving up their children would tend to be of much lower economic status than adopting mothers, and therefore much less likely to have adequate medical insurance.

would demand to give up their children consists mostly of the medical costs they incurred during pregnancy and birth. The emotional toll of giving up a baby is not a cost the adoptive mother would face if she bore the child. Landes and Posner's argument to the contrary highlights the problem we are illustrating, that legal economists frequently ignore (or intentionally attempt to contradict) most people's feelings about what the law should be. This tendency may have sharply deleterious consequences, as we argue below.

B. Racial Discrimination

In his landmark 1992 book, Forbidden Grounds,[17] Richard Epstein relied on economic arguments to explain why the laws prohibiting racial discrimination in employment should be repealed.[18] Epstein's arguments are no more premised on malice towards racial minorities than Landes and Posner's were based on hatred of babies. To the contrary, Epstein believes that laws prohibiting racial discrimination actually harm racial minorities (along with everyone else) and that repealing these laws would benefit everyone.[19]

Epstein premised his case on the notion that discrimination may sometimes reduce agency costs and therefore prove efficient.[20] Governance costs rise as the tastes of the firm's members and employees diverge.[21] One way to reduce agency costs and promote harmony within the firm, then, is to hire employees with similar tastes.[22] Employees who share the same tastes in music, Epstein illustrated, will not quarrel over

[17] EPSTEIN, *supra* note 2.
[18] Epstein also argued against laws prohibiting gender, age, and disability discrimination. *Id.* at 9.
[19] *Id.* at 57-75.
[20] *Id.* at 59-65
[21] *Id.* at 57.
[22] *Id.*

what type of music to play in a common workspace.[23] Finding workers with similar tastes will often result in hiring a disproportionate number of some particular racial minority, whose members may be more likely to share some tastes than the components of a more diverse group.[24]

Another way to reduce agency costs is to recruit through a third party referrer who implicitly bonds the workers' performance.[25] For an example, Epstein drew on the case of the Daniel Lamp Company.[26] The Daniel Lamp Company established relationships with two Hispanic groups, the Spanish Coalition and the Latino Youth Organization, which each recommended unskilled workers for employment.[27] The organizations then had a vested interest in ensuring that the workers they recommended were of high quality, since otherwise the company would stop trusting them for referrals and they would lose a valuable opportunity for their members.[28] This system resulted in cheap bonding for the workers and an inexpensive source of reliable labor, helping to maximize the company's earnings.[29] The system also resulted in the company hiring mostly Hispanic workers and commensurate liability under the antidiscrimination laws.[30]

Finally, Epstein pointed out that if bigots concentrated themselves in firms that discriminated against racial minorities, firms that did not discriminate would end up relatively bigot-free. Without the interference of antidiscrimination laws, this would be likely to occur. Bigots would likely to seek out firms that discriminated, since they strongly preferred to avoid contact with racial minorities. By means of the bigots' self-

[23] *Id.* at 61-62.
[24] *Id.* at 63-64.
[25] *Id.* at 70-71.
[26] *Id.* at 70-71.
[27] *Id.* at 70.
[28] *Id.* at 70-71.
[29] *Id.* at 71.
[30] *Id.* at 70-71.

selection, firms that did not discriminate would have few bigots, even if the companies themselves were indifferent as to whether their employees were bigots (which is unlikely). Firms without bigots should be easier to manage and therefore face lower governance costs.[31]

Epstein fully understood that his proposal was alarming. On the very first page of his book he stated, "There is little question that a broad antidiscrimination principle lies at the core of American political and intellectual understandings of a just and proper society, not only in employment but also in housing and public accommodations, medical care, education, indeed in all areas of public and private life."[32] He reiterated this point several times in different ways, stating that the antidiscrimination statutes command "enormous support" from U.S. elites,[33] quoting President George Herbert Walker Bush vilifying discrimination as a "'fundamental evil that tears at the fabric of our society,'"[34] and claiming that even as strong and independent an institution as the United States Supreme Court could not "withstand the pounding that would result of it undertook a frontal assault on the basic antidiscrimination norm."[35] Nevertheless, he concluded that the antidiscrimination statutes should be repealed.[36] Discrimination should be legal because it was often rational and wealth-maximizing.[37]

C. Insider Trading

Our final example comes from the world of the securities markets. For most people who buy or sell publicly trades securities, stock transactions are anonymous and

[31] *Id.* at 74-75.
[32] *Id.* at 1.
[33] *Id.* at 3.
[34] *Id.* at 3.
[35] *Id.* at 6.
[36] *Id.* at 9 (advocating the repeal of Title VII as it applies to private employers operating in competitive markets without legal protections against new entries).
[37] *Id.* at 68-69.

impersonal. Most market participants rely on the integrity of an enormous market and the hard work, intelligence, and powerful incentives of literally thousands of sophisticated traders and analysts to produce the most accurate stock prices possible based on the information publicly available. While some market participants are better at divining the future direction of equity prices than others – witness Warren Buffet – we can all at least take comfort in the thought that the playing field is level.

Some potential buyers and sellers, however, may have a significant advantage unconnected to their native talents or diligence. Officers, directors, employees and agents of public corporations may, in the course of their duties, learn important information – information that could affect market prices – that has not been released to the public. For these insiders, trading in their company's stock is like playing poker with a marked deck only they can read.

Largely for this reason, insider trading has been prohibited in the United States for generations. The primary justifications for the ban have always been fairness and the perception of fairness. The ban's advocates have argued that it is unfair to allow corporate insiders who possess material, confidential information to trade with market participants who lack that private information.[38] They have also argued that investors will not participate in a market they perceive to be unfair, or rigged in favor of insiders.[39]

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[38] *See In re Cady Roberts & Co.*, 40 SEC 907, 912 (1961) (concern that uninformed may be exploited); Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Assessment*, 70 CAL. L. REV. 1, 2 (1982) (rule's acceptance rests in intuition that insider trading is unfair); Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1321 (1999) (rationale is that insiders should not be permitted to take advantage of shareholders); Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 124-125 (1982) (insider trading violates fairness goals).

[39] *See* H.R. Rep. No. 98-355, at 4 (1984) (insider trading undermines confidence in the markets); Victor Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 356-57 (1979) (Congress' purpose in enacting the securities laws was in part to restore public trust in the markets).

The laws banning insider trading, then, are based both on a sense of fair play for its own sake and on a more pragmatic concern that the markets will not function if they appear to give some players an unfair advantage.

Despite these concerns, renowned legal economists Dennis Carlton and Daniel Fischel argued in the Stanford Law Review that insider trading should be permitted.[40] Carlton and Fischel acknowledged that many consider insider trading unfair, but concluded that the practice was efficient nonetheless.[41] They argued that insider trading would at least in some cases promote more accurate securities prices.[42] Insider trading provides an alternative avenue of communication from the firm to investors.[43] When the market detects insiders trading, it adjusts the company's stock price accordingly, bidding the price up higher if insiders are buying and reducing the price if insiders are selling.[44] The end result under ideal conditions may approach the effect of actually disclosing the inside information.[45] Companies may prefer to disclose through insider trading for a number of reasons, such as when disclosure would destroy the value of the information (such as the presence of oil under land the company is considering buying) or when the information is uncertain and the company wishes to avoid liability for a misdisclosure if the information turns out to be false.[46] Accurate pricing is wealth-maximizing for a

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[40] Carlton & Fischel, *supra* note 3. They are certainly not alone. *See, e.g.*, Edmund W. Kitch, *The Law and Economics of Rights in Valuable Information*, 9 J. LEGAL STUD. 683, 718-19 (1980) (permitting insider trading would result in more accurate securities prices); Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 565-76 (1970) (same).

[41] *Id.* at 858, 880-882.

[42] *Id.* at 865-68.

[43] *Id.* at 868.

[44] *Id.*

[45] *Id.*

[46] *Id.* at 868.

number of reasons, but chiefly because correct prices permit investors to reduce their investments in discovering improperly valued securities.[47]

Carlton and Fischel also contended that insider trading would constitute a more efficient way to compensate and hire managers.[48] Shareholders desire compensation schemes that will induce managers to seek out and implement high expected value opportunities.[49] Legalizing insider trading may produce the correct incentives.[50] Insider trading rewards managers who discover good opportunities and put them into effect by permitting them to trade in advance of public knowledge of the company's imminent success.[51] Insider trading may prove a cheaper method of incentivizing managers than renegotiating each time a corporate opportunity arises or structuring complicated incentives contracts ex ante.[52] In addition, insider trading may turn out to be a valuable screening tool in selecting managers who will work hard and will take efficient levels of risks.[53] Since insider trading rewards hard-working managers who create profitable opportunities for the corporation, only such managers should be willing to accept insider trading as a substantial component of their compensation.[54] These are precisely the managers corporations generally want to hire.[55]

Carlton and Fischel acknowledged that insider trading might not always be efficient for every corporation.[56] They discussed numerous concerns that might render insider trading disadvantageous for some companies in some circumstances, such as the

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[47] *Id.* at 866-67.
[48] *Id.* at 869-72.
[49] *Id.* at 869-71.
[50] *Id.* at 870-71.
[51] *Id.*
[52] *Id.*
[53] *Id.* at 871-72.
[54] *Id.* at 871-72.
[55] *Id.*
[56] *Id.* at 861-66.

moral hazard problem and issues concerning disclosure timing.[57] The inherent unfairness of insider trading to non-insider market participants, however, received short shrift. In a few short paragraphs, the authors argued that if insider trading is efficient, and therefore increases the total resources to be divided, then it benefits both insiders and outsiders as a class.[58] In other words, since insider trading makes even outsiders wealthier than they would be without insider trading, the practice cannot be unfair.

These three examples – baby selling, employment discrimination, and insider trading – highlight the tendency of legal economists to treat fairness concerns as largely irrelevant to their policy recommendations. Legal rules that produce greater wealth should be chosen even if – perhaps especially if – they contradict commonly-held notions of justice and fair play. In Section III, we argue that this strategy is misguided under both wealth maximization and welfare maximization frameworks.

II. Wealth, Welfare and Fairness

In this section, we introduce two methodological difficulties. First, legal economists often focus on wealth as a proxy for maximizing welfare. However, it is social *welfare* that economists seek to enhance, and wealth is often a poor approximation of welfare. Second, legal economists discount people's preferences for fairness, at most mentioning that their proposals run contrary to these tastes. In this section, we argue that there is robust empirical evidence of people's preference for fairness and that this preference cannot be ignored in legal economists' welfare calculations.

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[57] *Id.* at 872-82.
[58] *Id.* at 880-82.

A. Wealth v. Welfare

Over twenty-five years ago, in a famous pair of articles, Richard Posner argued that the goal of legal economists should be to divine the policies that would promote wealth maximization, rather than welfare maximization.[59] While the extreme version of this view of wealth maximization as moral theory has been energetically criticized (and Posner himself has disavowed this view),[60] economists often defend wealth maximization models as a useful simplification that tracks social welfare.[61] More importantly, in practice legal economists overwhelmingly use wealth maximization models, rather than welfare maximization.[62]

This tendency courts frequent and substantial analytical errors. Wealth does not equate with welfare. To the contrary, under many circumstances people will willingly trade material goods for other values, such as distributional fairness or justice. Experience provides numerous examples of such choices, such as blood donations, charitable gifts, and wealthy people supporting more sharply progressive taxes. While considerable ingenuity has been devoted to developing strategic explanations for some of

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[59] Richard Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEG. STUD. 103 (1979); Richard Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487 (1980).

[60] *See* LOUIS KAPLOW AND STEVEN SHAVELL, FAIRNESS VERSUS WELFARE 35 n.41 (2002).

[61] *See, e.g., id.* at 37; Richard Posner, *Wealth Maximization and Tort Law: A Philosophical Inquiry in* PHILOSOPHICAL FOUNDATIONS OF TORT LAW 99-100 (David G. Owen ed., 1995) (defending the use of wealth maximization models in choosing legal rules). As Ed Diener and Martin Seligman explain:

> In microeconomics…, the standard assumption is that, other things being equal, more choices mean a higher quality of life because people with choices select courses of action that maximize their well-being. Because income correlates with number of choices, greater income is equivalent to higher well-being. This formulation is standard in economics, where income is seen as the essence of well-being, and therefore measures of income are seen as sufficient indices to capture well-being.

Ed Diener & Martin E.P. Seligman, *Beyond Money: Toward an Economy of Well-Being*, 5 PSYC. SCI. IN PUBLIC INT. 1, 2 (2004).

[62] *See, e.g.,* KAPLOW AND SHAVELL, *supra* note 60, at 100-103, 124-133, 174-203, 232-241, & 254-272 (using wealth maximization models).

these behaviors,[63] experiments such as the ultimatum game verify the widely-held intuition that wealth often yields to other values.[64]

Among the greatest challenges to equating wealth with welfare is the growing happiness research.[65] In arguing that the well-being should be pursued directly, Diener and Seligman note the many problems with assuming that money does buy happiness, including that there are diminishing returns for individuals' higher incomes and that increased societal wealth does not translate into increased individual happiness.[66] On the other hand, form of government, trusting communities, and religion increase well-being, but cannot be measured by wealth.[67] Moreover, even when income and well-being are related, the relationship is complicated. Money is more likely to buy happiness in poorer societies.[68] And, happy people tend to make more money, thus calling into question the causal relationship.[69] The focus on money may have played a role in simplifying the economist's task, but recent research reveals that economists have oversimplified it. Although we will doubtlessly need to continue to rely on money in some instances,[70] the happiness literature raises a flag of caution.

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[63] *See* ERIC A. POSNER, LAW AND SOCIAL NORMS (2000).

[64] For example, Ruben Durante and Louis Putterman recently conducted a fascinating experiment that found that a large majority of subjects were willing to give up a significant portion of the game's payoff in "taxes" in exchange for a more equal distribution of profits. *See* Ruben Durante & Louis Putterman, *Preferences for Redistribution and Perception of Fairness: An Experimental Study* (July 27, 2007). Available at SSRN: http://ssrn.com/abstract=1004573.

[65] Notably , there are a number of methodological difficulties with current happiness research. *See* Diener & Seligman, *supra* note 61, at 3-4.

[66] *Id.* at 5-6.

[67] *Id.* at 6-7.

[68] *Id.* at 7-8.

[69] *Id.* at 8-9.

[70] As Adler and Posner see it, abandoning the assumption that money impacts well-being would have profound implications:

> The premise that money has no impact on well-being would not merely explode CBA[cost-benefit analysis], by leading to undefined [compensating variations]. It would also have radical implications for other practices even more central to the legal system than CBA, such as judicial damage awards in tort and contract cases, antitrust law, and progressive taxation. The compensatory rationale for awards would evaporate.

B. Fairness

1. Fairness as a Preference

Within welfare economics, an actor's concern for fairness is simply one preference among others. Hence, to the extent that citizens express a preference for fairness, this preference – like preferences for money or happiness – must be taken into account. Some welfare economists label this preference for fairness, a "taste for fairness."[71]

For our purposes here, we will use the term "fairness" as a rough proxy for other-regarding preferences that deviate from the presumption that individuals prefer those things in their rational self-interest. That is, individuals may have fairness preferences in equality and proportionality, but they may also be motivated by altruism or envy.[72]

Because this essay is an internal critique of law and economics, we will take seriously the claim that fairness concerns are simply preferences. But before doing so, we wish to note two ways in which fairness may be more than simply a preference.

First, welfare economists must make initial determinations about how to aggregate preferences. Does everyone count? Does everyone count equally? These questions cannot be answered without making value judgments. Moreover, a selection among distributive approaches will have an effect on the outcome of the social welfare function. For example, a decision to count everyone's preferences equally yields a very different result than counting only the preferences of white males. Crucially, the decision

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Matthew D. Adler & Eric A. Posner, *Happiness Research and Cost-Benefit Analysis* (forthcoming Journal of Legal Studies) available at http://ssrn.com/abstract=999928, (manuscript at 19).

[71] As described by Kaplow and Shavell, individuals may have "a taste for a notion of fairness, just as they may have a taste for art, nature, or fine wine." KAPLOW & SHAVELL, *supra* note 60, at 21.

[72] For an empirical attempt to distinguish among these preferences, see Jeremy Clark, *Fairness in Public Good Provision: An Investigation of Preferences for Equality and Proportionality*, 31 CANADIAN J. ECON. 708 (1998).

between these possibilities must be made by a criterion outside of the welfare counting mechanism itself. Welfare economists must therefore make a critical decision – how to aggregate social welfare – on the basis of some value other than efficiency (such as "fairness") in order to perform any economic analysis.[73]

Second, many theorists believe that fairness concerns may trump otherwise welfare maximizing rules. In the hypothetical case "Surgeon,"[74] a surgeon seeks to cut up one healthy individual and distribute his organs to five sick individuals.[75] Theorists argue that even if this rule were welfare maximizing,[76] cutting up one individual would be impermissible because doing so would be appropriating him.[77]

At this point, however, we would like to put these two (substantial) concerns to the side. For the remainder of this essay, we will try to assess the strength of the "taste for fairness," and argue that, even when fairness is viewed as a taste, economists are paying too little attention to how this taste may undermine not only the legal rule that they are proposing but also the legal regime as a whole.

2. Evidence of the Preference for Fairness

A thorough empirical calculation must include all factors that could influence the result. Of course, some factors may not be statistically significant, and depending upon one's discipline and the need for exact calculations, some factors may be ignored. However, the mere lip service that is given to the taste for fairness within the legal

[73] On these points, see generally Michael B. Dorff, *Why Welfare Depends on Fairness: A Reply to Kaplow and Shavell*, 75 S. CAL. L. REV. 847 (2002).

[74] *See* Judith Jarvis Thomson, *The Trolley Problem*, *reprinted in* RIGHTS, RESTITUTION & RISK: ESSAYS IN MORAL THEORY 95 (1986).

[75] For the argument that such a rule would not be Pareto superior, see Kimberly Kessler Ferzan, *Some Sound and Fury from Kaplow and Shavell*, 23 LAW & PHIL. 73, 82 (2004).

[76] That is, assuming that this would not lead to great social instability and so forth (the very repercussions we discuss below).

[77] Larry Alexander, *Lesser Evils: A Closer Look at the Paradigmatic Justification*, 24 LAW & PHIL. 611, 615-616 (2005).

economist's typical empirical conclusions is utterly unacceptable. The taste for fairness is pervasive, and the preference for fairness is very strong.

At the outset, we note that we do not need to rely on empirical studies to make this claim. The taste for fairness is patent within our society. Children complain if a rule is "unfair" but not if it is inefficient. We teach our children what it means to deserve praise and blame. And, we teach our children not to discriminate against people of different sexes, races, or religions; to believe that humans may not be bought or sold; and to value fair play.

However, we can make our case beyond even these obvious observations. The taste for fairness runs deep. Consider first the capuchin monkey.[78] Scientists conducted tests in which they gave capuchins food in exchange for rocks.[79] Capuchins like cucumbers and happily exchange cucumbers for rocks.[80] However, capuchins prefer grapes to cucumbers.[81] (Who wouldn't?) During the test, the scientists gave some monkeys grapes for rocks and others cucumbers for rocks.[82] The cucumber-receiving monkeys stopped exchanging the rocks for food or refused to eat the cucumber – "a directly accessible food that they readily accept and consume under almost any other set of circumstances."[83] From this, the researchers concluded that capuchins "measure reward in relative terms, comparing their own rewards with those available, and their own efforts with those of others."[84] Thus, to a monkey, it is not simply about how many rewards one may receive, but how well off one is compared to others.

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[78] Sarah F. Brosnan & Frans B.M. de Waal, *Monkeys Reject Unequal Pay*, 425 NATURE 297(2003).
[79] *Id.* at 299.
[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] *Id.* at 298.
[84] *Id.* at 299.

Even among human beings, the scientific documentation of the taste for fairness is robust. Individuals have tastes for fairness that run contrary to rational actor assumptions. One study asked individuals how tickets should be distributed in a case in which demand exceeded supply.[85] The subjects' clear order of preferences was standing in line, then a lottery, then an auction.[86] Of course, economic predictions run in the exact opposite order – favoring auctions (he who values the ticket most will pay most) and disfavoring lines (which are wasteful).

Perhaps the most famous endorsement of fairness is the ultimatum game.[87] In the ultimatum game, two subjects are told that they will split a sum of money. One subject proposes how the two will split the money. The second subject then either accepts or rejects the offer. If the offer is accepted, the money is split according to the offer's terms. If the offer is rejected, neither subject receives anything. Purely rational actors in the proposing role would offer a split in which the offeror receives nearly all the money and the offeree receives next to nothing. Purely rational offerees would accept these offers because even very little money is better than nothing. Each subject plays the game only once, so there are no incentives to cooperate stemming from a repeat play strategy. In a result surprising only to economists, across many cultures offerors often propose a roughly even split (around 40% on average), and offerees faced with drastically unfair proposals frequently reject the offer.[88] In other words, the ultimatum game demonstrates

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[85] Daniel Kahneman, Jack L. Knetsch, Richard H. Thaler, *Fairness and the Assumptions of Economics*, 59 J. BUS. S285, S287 (1986).

[86] *Id.*

[87] *See* Joseph Neil Bearden, *Ultimatum Bargaining Experiments: The State of the Art*, available at SSRN: http://ssrn.com/abstract=626183 at 3-4 (November 2001); Werner Guth, *et. al*, *An Experimental Analysis of Ultimatum Bargaining*, 75 J. ECO. BEH. & ORGANIZATION 367 (1982).

[88] Bearden, *supra* note 87, at 5-7; Alvin E. Roth, *et. al*, *Bargaining and Market Behavior in Jerusalem, Ljubljana, Pittsburgh And Tokyo: An Experimental Study*, 81 AM. ECON. REV. 1068, 1070 (1991); Joseph Henrich, et al, *In search of Homo Economicus: Behavioral Experiments in 15 Small-Scale Societies*, 91

robustly that people willingly sacrifice their pecuniary self-interest to promote other values such as fairness.

These are but a few of the empirical studies that clearly demonstrate that individuals have a strong preference for fairness. Indeed, this preference is sometimes stronger than any preference individuals have to act in their rational self-interest. Because individuals weight fairness so heavily, any policy that seeks to enhance their welfare must take account of their fairness preferences.

3. Responses to Fairness

Given the empirical evidence of the taste for fairness, one should expect that fairness significantly figures into social welfare calculations made by legal economists. This, however, is not the case. Rather, legal economists seem to adopt one of two strategies. Some have simply ignored it. Others have attempted to explain fairness away.

More often than not, fairness is simply ignored. As Kahneman, Knetsch, and Thaler, have noted:

> The economic agent is assumed to be law-abiding but not "fair" – if fairness implies that some legal opportunities for gain are not exploited. This nonfairness assumption expresses a resistance to explanations of economic actions in moral terms that has deep roots in the history of the discipline. The central insight that gave rise to modern economics is that the common good is well served by the free actions of self-interested agents in a market.[89]

AM. ECON. REV. 73 (2001); Hessel Oosterbeek, *et. al*, *Differences in Ultimatum Game Experiments: Evidence From a Meta-Analysis*, 7 EXPERIMENTAL ECON. 171 (2004) (although exact percentages vary quite a bit, the average of the means of the offered shares is approximately 40%).

[89] Kahneman et al., *supra* note 85, at S286.

As Kahneman, Knetsh, and Thaler note, there are two possible reasons for this neglect – one substantive and one methodological.[90] The substantive claim is that one may believe that there is no real substantive content to fairness. If fairness concerns are really just charades for self-interest then there is no need to account for fairness needs separately. The methodological claim is simply this – things just get too complicated when theorists must take into account fairness calculations. If the benefit of economic modeling is answers, the more factors, the more complicated the model, the harder those answers are to come by.

Taking the methodological rationale first, we simply believe that this factor cannot be ignored. *Legal* economists are presumably making policy recommendations that they believe *should become the law*. The calculations may be complicated. However, if a theorist is going to advocate for a particular position as the welfare-maximizing one, then that policy should truly – all things considered – maximize welfare.

As for the substantive claim, it seems to us that the burden is on legal economists to *show* – through empirical data—that the impact of fairness is not statistically significant or is simply self-interest in disguise. However, given the current data that exists, the taste for fairness runs deep and must be accounted for, not ignored.

Some legal economists attempt to undermine the role of fairness by explaining our attachment to it. For instance, Harvard legal economists Louis Kaplow and Steven Shavell present a two-step argument against fairness.[91] First, they link fairness theories to social norms. Here, they assert a causal thesis to explain why the reader is attracted to fairness, arguing that the attachment to fairness theories comes from their similarity to

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[90] *Id.*
[91] KAPLOW & SHAVELL, *supra* note 60, at 63, 136-139, 357-59.

social norms that are inborn (via evolution) or inculcated. Second, Kaplow and Shavell argue that social norms themselves should not provide an independent basis for making legal policy decisions. They claim that social norms serve as rules of thumb for advancing social welfare and have evolved or were indoctrinated for this purpose; hence, because welfare economics can calculate social welfare directly, reliance on these social norm proxies is unnecessary.[92]

There are two problems with this argument. First, a causal explanation of a belief does not undermine the truth of that belief. As Jules Coleman noted, "the view that the existence of a causal explanation of the facts that someone holds or asserts a particular claim undermines the truth of the claim asserted simply cannot be sustained."[93] Indeed, as Coleman notes, even if evolution selected for beliefs, why would it select for false beliefs over true ones?[94] Second, Kaplow and Shavell's move from the observation that social norms enhance welfare to the claim that they were inculated for this purpose is a *non sequitur*.[95] There are other alternative explanations for why fairness beliefs may often be welfare enhancing. Fairness beliefs and social norms may be linked by a common morality, and, even if not aimed at *maximizing* welfare, it would be a very short-lived morality that did not somehow enhance it.

Ultimately, taking Kaplow and Shavell's claim to its logical conclusion would lead to a complete refusal to count fairness at all. Although Kaplow and Shavell claim to be willing to include fairness as a preference (when empirically demonstrated, though

[92] *Id.* at 68, 71.
[93] Jules L. Coleman, *The Grounds of Welfare*, 112 YALE L. J. 1511 (2003).
[94] *Id.* at 1534.
[95] *See generally* Ferzan, *supra* note 75, at 93.

they doubt this will often be the case),[96] their argument – that fairness is just a rough proxy for a welfare-enhancing standard – amounts to an argument that fairness is just a mistaken preference. That is, people, were they to know how a legal rule would effect them, would no longer prefer the fair rule. However, given that Kaplow and Shavell claim that mistaken preferences are not entitled to any weight,[97] it seems that they cannot give any weight to fairness. Because their argument dissolves fairness completely, Kaplow and Shavell will have to put forth a more compelling argument for why it is simply a mistaken preference. To this point, they have not met their burden.[98]

III. The Perils of Ignoring Fairness

In this section, we argue that, when theorists fail to take fairness into account, their results may be neither wealth nor welfare maximizing. The rule itself may not maximize wealth or welfare because it defeats reasonable expectations or even instigates resistance. Additionally, the legal rule may have significant negative externalities – it may undermine the legal system as a whole.

A. Getting the Calculation Wrong: The Failure of the Legal Rule to Maximize

1. Defeating Reasonable Expectations

In a democracy, people should and generally do expect the country's laws to be fair and to make sound intuitive sense. For small-scale transactions, those whose value does not justify paying for sophisticated legal assistance, the participants are likely to rely primarily on their intuition as to the content of the governing background rules. These

[96] KAPLOW & SHAVELL, *supra* note 60, at 11-12, 78, & 431-36.
[97] *Id*. at 23.
[98] Moreover, if Kaplow and Shavell wish to contend that fairness is not simply a mistaken preference, and can therefore be taken into account, then they must face the potential consequence that these preferences could undermine their current conclusions. *See* Mark D. White, *Preaching to the Choir: a Response to Kaplow and Shavell's Fairness Versus Welfare*, 16 REV. POLI. ECON. 507, 512 (2004). The potential for these sorts of preferences to undermine seemingly welfare-maximizing policy prescriptions is the subject of the next section.

expectations are reasonable and will be, in the aggregate, heavily relied upon. Legal rules that go against the grain of expectations will be ignored in such transactions, rendering even the most interesting and potentially efficient rules useless in instilling appropriate incentives. A large part of any rule's value lies not in the results it produces in litigation but in the shadow it casts on behavior outside of litigation. These motivating effects are severely diluted to the extent they fall below the radar of their targets and run counter to intuition.

Worse, litigation over such small-scale transactions will likely unwind the parties' precautions and produce unjust windfalls. At the time they enter into their transaction, both parties likely think the governing rule is the intuitive rule. That rule allocates rights to the parties in a way they both understand and consider to be fair. They build the transaction around the rule as they think it to be, and price the deal accordingly. They also take whatever steps they think prudent to ensure performance and to insure against risk based on their understanding of how the law will allocate each party's rights and duties. If the parties later have a dispute arising from the transaction, the court will declare victory for one party over the other on the basis of the actual legal rule in effect. When the legal rule produces a different result from the rule the parties thought applied, their preparations are likely to go awry. Plus, the surprised victor will gain a windfall at the expense of the dismayed loser. The parties agree to the contract price with a common understanding that they are allocating certain entitlements to each. When the court reverses the parties' distribution, it essentially forces the losing party to pay for the entitlement twice: once as part of the contract price and a second time as damages from the litigation.

Although high-value transactions guided by expensive counsel seem less vulnerable to this phenomenon, rules governing obscure or rare aspects of the transaction may suffer from a similar dynamic. Even experienced lawyers are unlikely to be aware of rules that cover relatively rare situations. A lawyer uncertain about the law could expend resources in research to discover the truth, but that search will occur only when the lawyer is aware of his or her ignorance. In the more likely situation in which a lawyer is unaware that a special exception exists, that exception may be ignored until it is too late, again defeating expectations.

To understand this dynamic more concretely, imagine that a state adopted a law reinstating the doctrine of *caveat emptor* (buyer beware) for a narrow class of contracts only, say contracts dealing with the sale of used cars by used car dealers. Ignoring the expectation problems described in this section, such a rule might be efficient. In such sales, both parties can easily be placed on roughly equal footing. While the seller possesses more information about the car's history, that advantage can easily be eliminated by the buyer's hiring a mechanic to inspect the car or making the sale contingent on a complete disclosure of the car's maintenance records. In this context, then, there may not be any great need to overcome legal economists' usual presumption, illustrated by all three of our introductory examples, that freedom of contract should triumph over any regulatory impulses to protect one side or the other in a transaction. Our claim is not that such a rule would *actually* be efficient – we can certainly see some arguments that alternative rules might be better, such as the advantages of imposing liability on the party with more information *ex ante* – but only that there are sufficiently strong arguments in its favor that it is reasonable to suppose it *might be* efficient.

Once we consider the rule's effects on settled expectations, however, the rule's efficiency becomes much more doubtful. In the last few generations, American consumers have increasingly come to expect a certain level of fairness protection in their transactions, especially in their transactions with relatively sophisticated counterparties. In fact, this *caveat emptor* proposal would represent a significant change in the existing law of most states. The sale of a car is regulated by Article 2 of the Uniform Commercial Code, since cars are movable goods.[99] Article 2 applies certain implied warranties in the absence of express disclaimers.[100] One of these is the Implied Warranty of Merchantability, which provides that, unless excluded, a warranty is implied in the sale of goods by a merchant (such as a used car dealer) that the goods will be "merchantable," meaning essentially that they are fit for the ordinary purposes for which such goods are used.[101] Many states provide even more protection in the form of "lemon laws," which provide enhanced remedies when dealers sell consumers cars that are in particularly poor shape and cannot be adequately repaired.[102] The proposed *caveat emptor* rule, by contrast, would not imply any warranties at all. Instead, the background default rule would provide that buyers of used cars took them on a strictly "as-is" basis, even if they turned out not to run.

The *caveat emptor* rule, then, would represent a sharp diversion from consumers' current expectations. Consumers buying used cars from dealers expect a certain level of

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[99] Uniform Commercial Code § 2-102 (Article 2 applies to contracts for the sale of goods) and §2-105 (goods are all things that are movable, with certain exceptions not relevant here).

[100] *See, e.g.*, Uniform Commercial Code §§ 2-314 (Merchantability) and 2-315 (Fitness for a Particular Purpose).

[101] Uniform Commercial Code §2-314.

[102] *See, e.g.*, 8 Ala. Code § 8-20A-2 (dealer must refund purchase price and pay any damages for car that cannot be brought into conformity with express warranties); Cal. Civil Code §§ 1793.22 - 1793.25 (same); Fl. St. Ann. §§ 681.10-681.118 (same); NY Gen. Bus. Law § 198-a (same). For a more complete list, *see* *http://www.carlemon.com/lemonstat.html* (last checked January 4, 2008).

basic protection. While at one time this may not have been true – witness the still lingering reputation of used car dealers as untrustworthy – we suspect Article 2 and the passage of lemon laws in many states have largely changed consumers' expectations. Consumers now are much less likely to take precautions when buying a used car from a dealer, such as having the car inspected by a mechanic or insisting on a written warranty. Should the law change to a regime of *caveat emptor*, these consumers would go unprotected and often end up with a "lemon" without recourse against the dealer. Over time, consumer groups might manage to educate the public about the new need to take greater care, but until then (and for many consumers, even after then), consumers as a group would likely suffer a substantial loss from the adoption of the new rule. This loss detracts greatly from the proposal's efficiency, perhaps enough to outweigh whatever gains might be made from the increased freedom of contract. At a minimum, legal economists have paid insufficient attention to the effect on settled expectations, an important factor in measuring a proposal's efficiency.

2. Instigating Resistance

While the last section discussed a fairly technical problem that is often overlooked by economists, in this section we focus on an issue further afield from the rational actor model legal economists favor. Legal economists tend to think of people's attitudes towards rules as reflective of their underlying pecuniary interests. Corporations care about maximizing their profits; individuals care about maximizing their income. Both corporations and individuals will support policies that enhance their financial prospects and oppose those policies that will likely cause them economic harm. But actual human beings often care most about concerns that are entirely non-pecuniary and will sometimes willingly suffer financial losses in order to further other interests. Although it would be trite to state this in any non-economic context, human beings often care deeply about justice, equality, freedom, fairness, and religion, to name but a few of humanity's core non-pecuniary concerns.

Non-pecuniary interests are often the most powerful motivators of human behavior, and social engineers such as legal economists ignore them at their peril. In particular, individuals who find a particular law offensive may actively attempt to circumvent it and undermine its enforcement even when such opposition is costly. This behavior may impair the efficiency benefits that would come from broad compliance.

As an example of this problem, let us imagine that Congress adopted Richard Epstein's proposal to eliminate the antidiscrimination statutes. Epstein argued that permitting discrimination would be efficient mostly because it would permit companies to reduce agency costs.[103] He posited that some companies would choose to hire primarily members of a particular race as a way to unify workers' tastes and make the business easier to govern.[104] Other companies that did not discriminate would also benefit from this rule, because the discriminating companies would siphon off most of the bigots, who presumably are difficult to manage in racially diverse companies.[105]

But what would actually happen to a company that adopted an expressly discriminatory hiring policy? Anti-discrimination norms have taken deep roots in the past two generations. Under these conditions, who would do business with a company that blatantly discriminated in hiring? Even a company that adopted its discrimination policy quietly would risk exposure every time an applicant of a disfavored race was

[103] *See supra* section I.B.
[104] *See id.*
[105] *See id.*

rejected despite excellent qualifications. In fact, it would be difficult for a company to reap the benefits Epstein identified without making some public statement of its policy, so that members of the privileged race would know to apply in greater numbers (not to mention the bigots). Once a company's discrimination policy was revealed to the public, it would no doubt face immediate public condemnation and boycotts organized by groups representing the excluded races. Indeed, the boycotts would likely be joined by groups representing every race and religious group, since no race (and no representative group) would want to be seen as condoning racial discrimination. It is difficult to imagine that any company that stuck to an express discriminatory hiring policy could long survive, regardless of the policy's legality. The apparent efficiencies Epstein argued could be gained by eliminating the legal restrictions on racial discrimination evaporate once we take into account people's likely resistance to laws they strongly oppose.[106]

Epstein's proposal represents perhaps an extreme, in that nearly everyone at least publicly expresses opposition to racial discrimination. Other proposals might be less universally condemned and therefore receive less effusive opposition. But our point holds true for any policy that a sizable group passionately disapproves on principled grounds. A sufficiently outraged opposition will take steps to undermine the law it disputes, even when such opposition's expense far outweighs any anticipated material benefits from a policy change. The resulting costs should be taken into account when determining if a proposed law is truly wealth maximizing.

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[106] Epstein might contend that our analysis proves his point, that laws forbidding racial discrimination are unnecessary, since the same result – nondiscriminatory hiring – can be achieved without them. But this is not how he justified his argument in Forbidden Grounds. Instead, there he relied on the efficiencies that would result from permitting discrimination. More importantly, our purpose is not to argue the merits of any particular policy proposal but to demonstrate that legal economists frequently overlook the important consequences that result from individuals' strong opposition to some legal rules.

B. The Hidden Externalities of Unfair Rules: Undermining Moral Norms and Legitimacy

1. Why Citizens Obey the Law

Why do people obey the law? This question poses a difficult puzzle, especially for economists. For example, there are many goods and services we would very much enjoy consuming but which, as academics, we cannot easily afford. Why do we refrain from simply taking them? Why, in short, do we obey the law prohibiting us from stealing?

Economists' answer focuses on deterrence. The law induces obedience by establishing appropriate incentives. We obey the law because the law ensures that it is in our interests to do so.[107] The law can set up these incentives either by promising rewards for compliance or by threatening punishment for disobedience.

The law's success in coaxing obedience depends on the credibility of the threatened punishment which in turn hinges on both the likelihood of detection and the magnitude of punishment.[108] If we believe we are almost certain to be caught and punished, we are much less likely to steal than if we believe we are likely to escape with the stolen goods. Deterrence is costly. To make the threat of punishment credible, a government must invest heavily in police, courts, and prisons, both to increase the perceived risk of capture and to actually imprison those who are caught and convicted. For this reason, economists' vision of the law's goal is not necessarily to achieve perfect deterrence – and therefore perfect obedience – but rather to find the point at which the

[107] *See generally* Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POLI. ECO. 169 (1968)
[108] *Id.* at 176.

next dollar spent on deterring crime yields less than one dollar's worth of crime prevention.[109] The goal, in other words, is an efficient level of crime.

Though the workings of deterrence are fine in theory, in practice, an efficient level of crime is elusive. As Paul Robinson and John Darley have documented, there is little reason to believe that criminal law deters (at least through this mathematical formula).[110] Between the low chance of being caught, convicted, and sentenced to prison, the prison sentence itself is unlikely to have a strong deterrent effect.

Indeed, while economists believe that citizens obey the law because they are threatened into obedience, other scholars who have studied this question take a broader view of the possible causes of obedience.[111] Sociologists, social psychologists, and political scientists argue that important factors in addition to deterrence include peer attitudes towards crime, internal moral norms, and the legitimacy of the government institutions that create, administer, and enforce the law.[112] Deterrence and peer attitudes are both externally imposed methods of achieving obedience, while internal moral norms and legitimacy are internally motivated sources of compliance.[113] These four sources of obedience are interrelated, so that a change in one may have a greater or lesser impact through resulting changes in the others.

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[109] *See id.* at 170; *see also* Keith N. Hylton, *The Theory of Penalties and the Economics of Criminal* Law, 1 REV. L. & ECON. 175 (2005)(reconciling Becker's optimal level of crime approach with Posner's full deterrence approach).

[110] *See* Paul H. Robinson & John Darley, *Does Criminal Law Deter? A Behavioural Science Investigation*, 24 OXFORD J. LEG. STUD.173 (2004).

[111] *See* TOM TYLER, WHY PEOPLE OBEY THE LAW 15 (1990).

[112] *See generally id.*; Mark D. White, *A Social Economics of Crime Control (Based on Kantian Ethics) in* LAW & ECONOMICS: ALTERNATIVE ECONOMIC APPROACHES TO LEGAL AND REGULATORY ISSUES (Margaret Oppenheimer & Nicholas Mercuro, eds. 2005); Paul H. Robinson & John M. Darley, *The Utility of Desert*, 91 NW. L. REV. 453 (1997).

[113] *See* TYLER, *supra* note 111, at 23-26.

In some cases, deterrence is a factor. Material incentives are an important determinant of human behavior. Not surprisingly, since this is the element economists favor, incentives are the factor least likely to be directly affected by the choice of counterintuitive or apparently unfair rules. As long as the incentives are clear and well-known, they should tend to make the desired behavior more likely (and the undesired behavior less likely). But the results frequently will be less straightforward than economists predict, depending on the remaining three factors.

Peer attitudes towards compliance with the law, in contrast, may tend to undermine obedience of rules that are surprising or seem unfair. Tom Tyler's seminal Chicago study of legal adherence demonstrated that people distinguish among different laws when asked whether their peers would disapprove if they were arrested for committing one of a series of crimes.[114] While only about half of respondents felt that their peers would disapprove if they were arrested for making too much noise, littering, speeding, or parking illegally, the vast majority of respondents predicted their peers would disapprove if they were arrested for drunk driving (86%) or shoplifting (89%).[115] Tyler's study demonstrated that anticipated peer attitudes vary with the seriousness or moral blameworthiness of the crime. Crimes that appear less blameworthy, either because they cause less harm or do not violate a core moral precept, garner less peer censure than those likely to cause great harm (such as drunk driving) or which do violate fundamental moral principles (such as the prohibition against theft). Laws that outlaw conduct that appears harmless or innocent are unlikely to provoke much peer criticism when they are violated. These rules are consequently less likely to be obeyed.

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[114] *See id.* at 44.
[115] *See id.*

Economists who focus solely on material incentives in predicting compliance will therefore greatly overstate the likelihood of observance of counterintuitive or seemingly unfair rules.

Like peer attitudes, internal moral norms are less likely to lead to enforcement of odd or immoral laws. Tyler's Chicago study demonstrated that most people feel that breaking the law is morally wrong, and that this is one of the major reasons why people tend to obey the law.[116] To the extent people do not feel a particular law parallels their personal morality, then, internal moral norms are far less likely to induce compliance.[117] This effect should prove particularly powerful when people believe a law opposes their morality. We see a dramatic example of this effect in abortion foes who bomb clinics. Although they know that destruction of property is illegal, they proceed because they believe their actions serve a higher moral purpose, that of preventing what they perceive to be legally sanctioned murder. They choose to violate laws they presumably agree with (those banning destruction of others' property) in order to prevent enforcement of a law they virulently oppose (that legalizing abortion). While this is an extreme example, it does illustrate the guiding principle: people are less likely to obey a law that is not reinforced by their internal moral norms.

The fourth and final source of obedience comes from a law's legitimacy. "Legitimacy" refers to the perceived obligation to obey.[118] Citizens may feel an obligation to obey a law or a legal authority (such as a leader, judge, or police officer)

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[116] *See id.* at 56.

[117] The Chicago Study also found that the vast majority of respondents said that people should obey a law even if goes against what they think is right. *Id.* at 46. This finding, however, must be read in conjunction with the studies that demonstrate that this measure of legitimacy declines among people who disagree with the government's substantive policy choices. *See infra* note 120.

[118] *See* TYLER, *supra* note 111, at 27-28; MAX WEBER, THE THEORY OF SOCIAL AND ECONOMIC ORGANIZATION 124-26 (A. M. Henderson and Talcott Parsons, trans., 1947).

when that law or authority stems from a process or institution that they feel creates an adequate justification for obedience.[119] For example, Americans who believe in representational democracy may feel that a statute passed by both the House and the Senate and signed by the President should be obeyed even if they disagree with the statute's substance. The institutions that promulgated the law are rooted in a principle – representational democracy – that most Americans feel rightly demands their obedience. As a result, those institutions have a great deal of legitimacy in American political culture and can often induce compliance even from those who dissent from particular policy decisions.

Legitimacy is a variable sociological characteristic, however, not a physical constant. The legitimacy of sources of law and those who enforce it may decline if the laws seem wrong or bizarre. As a result, people may stop obeying even laws that do not seem strange because the overall legitimacy of the system is undermined. Sociological studies support this notion that those who oppose the decisions of legal institutions also feel those institutions are less legitimate.[120] Legitimacy thus provides some maneuvering room for governmental agents to advance policies that may not be popular, but legitimacy is ultimately linked to a government's ability to fulfill its people's desires.[121] A government that advances laws that appear immoral or strange may find its legitimacy undermined. Legal economists should consider these risks when arguing for such proposals, because the harmful effects on the government's legitimacy may far outweigh

[119] *See* TYLER, *supra* note 111, at 28.

[120] *See id.* at 30; *see also* Anke Grosskopf & Jeffery J. Mondak, *Do Attitudes toward Specific Supreme Court Decisions Matter? The Impact of Webster and Texas v. Johnson on Public Confidence in the Supreme Court*, 51 POLI. RES. Q. 633, 647 (1998); Valerie J. Hoekstra, *The Supreme Court and Local Public Opinion*, 94 AM. POLI. SCI. REV. 89, 96-98 (2000); Walter F. Murphy & Joseph Tanenhaus, *Public Opinion and the United States Supreme Court: Mapping of Some Prerequisites for Court Legitimation of Regime Change*, 2 LAW & SOCIETY REV. 357, 374-77 (1968).

[121] *See* TYLER, *supra* note 111, at 30.

any marginal efficiency gained by adopting counterintuitive rules. Counterintuitive and/or unfair rules may sometimes prove wealth-maximizing. But that calculation is far more complex than most legal economists have heretofore acknowledged. Such rules may have nuanced effects on social wealth through their effect on expectations, their conflict with non-pecuniary interests, and their deleterious impact on citizens' tendency to obey the law.

Applying these findings of Tyler's and others, Paul Robinson and John Darley contend that the criminal law is best served by conforming to citizens' perceptions of just desert.[122] As they argue, criminal law serves an essential function in both shaping and enforcing moral norms.[123] When citizens perceive a rule to be unfair, this may undermine the criminal law's legitimacy and the willingness of citizens to defer to the law in unclear cases.[124] As Robinson and Darley forcefully argue, legal economists' prescriptions to deviate from desert are far from costless, but rather, may significantly undermine crime control.[125]

2. The "Flouting Thesis"

Very little has been done to test the empirical assumption that unfair rules will undermine overall faith in the justice system. Still, it seems that any theorist who argues that his counterintuitive rule is efficient is implicitly (albeit unwittingly) making the claim that, even taking into account the extent to which this rule undermines citizen respect for the law, it is still the best rule. And, because the legal economist is making

[122] Robinson & Darley, *supra* note 112.
[123] *Id.* at 457.
[124] *Id.* at 487.
[125] *Id.* at 478.

such a claim, the burden lies on the economist to address and to refute any arguments that this rule will be more detrimental than beneficial.

Moreover, preliminary research does confirm that the legal economist must take these concerns seriously. One theorist who has attempted to understand the extent to which an unfair rule will undermine overall faith in the system is Janice Nadler.[126] Nadler recently examined the assumed but unproven "Flouting Thesis." "When a person evaluates particular legal rules, decisions or practices as unjust, the diminished respect for the legal system that follows can destabilize otherwise law-abiding behavior."[127]

In one experiment, subjects were exposed to many newspaper stories including a series of stories that portrayed laws as just or unjust.[128] Then, for an ostensibly unrelated purpose, the subjects were asked to participate in a filling out a questionnaire on their likelihood of criminal behavior.[129] The questionnaire listed "borderline" crimes such as drinking underage, taking home office supplies for personal use, and making illegal photocopies of software.[130] As predicted, those subjects exposed to stories discussing unjust laws indicated a greater willingness to break the law than those exposed to news stories about just laws.[131]

Nadler also conducted two experiments involving mock trials. In the first experiment, undergraduate students served as subjects.[132] They watched a news story that depicted either a just or an unjust outcome.[133] They were then asked to participate in

[126] Janice Nadler, *Flouting the Law,* 83 TEX. L. REV. 1399 (2005).
[127] *Id.* at 1401.
[128] *Id.* at 1411-1412
[129] *Id.* at 1413-1414.
[130] *Id.* at 1414.
[131] *Id.* at 1415.
[132] *Id.* at 1417.
[133] *Id.*

a (supposedly unrelated) mock trial.[134] In this mock trial, the defendant stole a shopping cart and was clearly guilty; however, subjects also knew that because this was his third felony, the defendant would receive a life sentence with no possibility of parole.[135] In this study, the Flouting Thesis was not confirmed. There was no statistically significant correlation between the just or unjust prime and the decision to nullify.[136]

Nadler then conducted the study with different participants. She sent an email to over a thousand participants, ultimately yielding subjects 60% female, 82 % white, mean age of 37, with 66% from the United States.[137] These subjects read the news story (rather than watching it on television) and then read a description of the mock trial, and were asked their verdicts.[138] Under these conditions, the Flouting Thesis was confirmed.[139]

There is certainly more empirical work to be done. Nadler's research confirms, however, that the "Flouting Thesis" is not just a matter of theoretical concern. Unfair rules may ultimately undermine the law itself.

Let us return to the proposals with which we began. Imagine that laws were enacted that allowed for baby selling, discrimination, and insider trading. We now see that these sorts of laws may undermine the law's overall legitimacy. If most people believe that discrimination is acutely wrongful, then they will view the law as making a profound moral mistake in allowing for discrimination. As mentioned above, it is entirely possible that they would then be less willing to defer to the law as a source of moral advice when they are unsure of what to do. Thus, even if these laws are wealth or

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[134] *Id.* at 1418.
[135] *Id.* at 1418.
[136] *Id.* at 1420
[137] *Id.* at 1423.
[138] *Id.* at 1424.
[139] *Id.* at 1424-25.

welfare maximizing in the individual case, they may ultimately have significant external costs that do not render them wealth or welfare maximizing when considering the legal system as a whole.

We also note that there is another possibility: citizens believe that the law is giving them moral advice, and they then come to believe that these wrongful acts are acceptable even in situations beyond the legal economists' calculations. For instance, assume that Carlton and Fischel's proposal is adopted and insider trading is legalized. Once the law becomes understood as endorsing these "unfair" practices, citizens may view it as more permissible to engage in activity the social norm (and even the law) forbids. Rather than recognizing that insider trading is a rather narrow exception to the norm against cheating, citizens may cease to believe in a norm of fair play. If individuals with inside information may permissibly use this information to their material advantage, citizens may decide that there is nothing wrong with failing to reveal a material defect in their home or their used car. And, what is a little bit of income tax evasion if insiders are permitted to cheat?

3. Undermining Rule of Law Values

There is one final way in which the law may lose its power. The legal rule may undermine the social norm, and the fairness belief itself. That is, even assuming that Kaplow and Shavell are correct and fairness rules are but imperfect proxies for complex social welfare standards, the economist cannot ignore the value of having rules.[140] When legal economists urge that we look beyond fairness beliefs to see whether in any particular case a rule is maximizing, they are choosing between the value of rules and the value of standards. This trade-off must also be accounted for in their calculations.

[140] *See supra* note 92 and accompanying text.

The rule versus standards debate is perhaps most famously embodied in the debate between Oliver Wendell Holmes and Benjamin Cardozo. To Holmes, the "featureless generality" of negligence would ultimately give way to specific *per se* rules, such as "stop, look, and listen."[141] But Cardozo had the last word, holding that such *per se* rules could not take into account all the circumstances so as to adjudicate correctly negligence liability in future cases.[142]

There are values to having rules as opposed to standards.[143] First, rules can solve physical coordination problems. In situations in which there are several different (and incompatible ways) to resolve a problem (for example, which side of the street to drive on), a rule can offer a solution.[144] Rules can also solve social coordination problems. To the extent that the morally right thing to do turns in part of what others are likely to do (for instance, a prisoner's dilemma), rules provide a basis for prediction.[145]

But rules have other values as well. The rule promulgator may have greater moral or factual knowledge than a citizen.[146] Additionally, rules help avert errors. When a complex decision must be made, actors who must decide under a standard – analyzing a multitude of factors – may simply get the calculations wrong.[147] And, by having a rule, decision-making costs are reduced.[148] As Larry Alexander and Emily Sherwin have explained, "The quality that identifies a rule and distinguishes it from a standard is the

141 *See* Baltimore & O.R. Co. v. Goodman, 275 U.S. 66, 70 (1927); OLIVER WENDELL HOLMES, THE COMMON LAW 111 (1881).

142 Pokora v. Wabash Ry. Co., 292 U.S. 98, 104 (1934).

143 *See generally* LARRY ALEXANDER & EMILY SHERWIN, THE RULE OF RULES: MORALITY, RULES, & THE DILEMMAS OF LAW ch. 1 (2001).; FREDERICK SCHAUER, PLAYING BY THE RULES (1991). For a discussion of rules versus standards in the context of drafting criminal statutes, see LARRY ALEXANDER, KIMBERLY KESSLER FERZAN, & STEPHEN J. MORSE, A CULPABILITY-BASED THEORY OF CRIMINAL LAW ch. 8 (forthcoming Cambridge University Press 2008).

144 *See* ALEXANDER & SHERWIN, *supra* note 143, at 56; SCHAUER, *supra* note 143, § 7.7.

145 *See* ALEXANDER & SHERWIN, *supra* note 143, at 57-58.

146 SCHAUER, *supra* note 143, at 55.

147 *Id.* at 150.

148 *Id.* at 137.

quality of determinateness. . . . [A] rule is a posited norm that fulfills the function of posited norms, that is, that settles the question of what ought to be done."[149]

Despite the values of rules, the problem is that rules may be overinclusive.[150] This is, of course, Kaplow and Shavell's complaint. If the standard is welfare maximization, and a fairness rule is but a rough proxy, the rule may sometimes be wrong.[151] Interestingly, however, rules are effective only because citizens do not frequently question whether they should follow a rule in any particular case.[152]

For our purposes, what is essential to note is that *even if fairness rules only serve a proxy function*, undermining that function may have devastating effects in cases in which we want citizens to follow the rule. Ultimately, the value of legal rules is consequentialist. We pursue the Good through indirect rules, rather than through direct calculations, because we are more likely to achieve the Good indirectly.[153] Thus, the stability of these sorts of rules is required for us to be able to achieve the Good in the vast majority of cases.[154] Hence, even if the underlying consequentalist standard (assuming this is what underlies the rule, of course) dictates that discrimination, or cheating, or baby selling is the appropriate course in one specific set of circumstances, this sort of deviation from the norms of fairness and equality may undermine the value of the rules themselves. A legal economist cannot afford to ignore such consequences.

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[149] ALEXANDER & SHERWIN, *supra* note 143, at 30.

[150] Rules may also be underinclusive. That is, the reason that justifies prohibiting conduct *a* may also extend to conduct type *b*, but the rule may apply only to conduct type *a*. SCHAUER, *supra* note , at 32-33.

[151] ALEXANDER AND SHERWIN, *supra* note 143, at 35; *id.* at 32.

[152] *See generally* Larry Alexander & Emily Sherwin, *The Deceptive Nature of Rules*, 142 U. PA. L. REV. 1191 (1994).

[153] *See* Larry Alexander, *Pursuing the Good-Indirectly*, 95 ETHICS 315, 317-319 (arguing that we need "indirect consequentalism" because for some practices pursuing the good directly would be self-defeating).

[154] This still creates the paradox of what to do when the rule does not promote the Good in an individual case. *See id* at 319-321.

IV. The Unexamined Market

There is, perhaps, a more interesting market that we should explore: the market for this sort of scholarship. The Stanford Law Review, the Journal of Legal Studies, and Harvard University Press – the publishers of the examples with which we began – are extremely prestigious. To the extent that the publishers seek to publish only the best and aim to signal that the work meets such standards of excellence, why is it that there is such a reward structure for these sorts of counterintuitive answers?

In our view, the failure to account for fairness preferences is a fatal flaw in these proposals. By the measure of their own discipline, legal economists are ignoring a variable that affects their ultimate conclusions. It is therefore significantly troubling that publishers who should be evaluating these papers are more influenced by the creative and countintuitive nature of the proposals than their rigor.

Of course, because we have argued that one must consider the externalities of one's proposals, we should consider whether the legal academy is better or worse off for these contributions. There are significant worries here. The value placed on counterintuitive thinking may lead young scholars to believe that this is the only sort of policy recommendation that should be made – and that unless they, too, come up with bizarre and outlandish ideas, they will never advance in the academy. (We know people who think this.)

Another concern is that these sorts of proposals can bring the academy into disrepute. If the ivory tower is not just a tower, but a tarnished tower, legal academics create more distance between themselves and actual policy makers. How many politicians would like to be viewed as aligned with "baby selling" and discriminatory hiring practices? Casting these proposals in this rhetoric, and taking economics to the extreme may not result in better public policy – just politicians with no trust in the legal academy.

On the other hand, there are competing positive benefits. We might question whether rewarding these sort of proposals encourages creativity. Then, even if these proposals are not welfare maximizing, encouraging this sort of thinking may maximize welfare.

This is an empirical question. But we will give one example. At a recent Association of American Law Schools meeting, Professor Ian Ayres discussed his career path. When asked what "turned him on" professionally, he replied, "intellectual perversity."[155] Now, Ayres is the author of one counterintuitive proposal that we would likely condemn. In a 1989 article,[156] Ayres and his co-author Robert Gertner famously introduced the concept of "penalty defaults."[157] At that time, when faced with an incomplete contract, commentators had urged courts to set default rules as what the parties would have wanted.[158] Ayres and Gertner, however, argued for penalty defaults that are set "at what the parties would not want – in order to encourage the parties to reveal information to each other and to third parties."[159] "Penalty defaults are designed to give at least one party to the contract an incentive to contract around the default rule and therefore to choose affirmatively the contract provision that they prefer."[160]

[155] *See* Ian Ayres, Paul H. Robinson, Carol Sanger, & Kimberly Kessler Ferzan, *Crafting a Scholarly Persona*. Available at SSRN: http://ssrn.com/abstract=998015
[156] Ian Ayres and Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989).
[157] *Id.* at 91.
[158] *Id.* at 89.
[159] *Id.* at 91.
[160] *Id.*

This is exactly the sort of policy that defeats reasonable expectations. Indeed, the entire goal is to defeat such expectations so that parties will negotiate around the penalty default. However, the value of such a rule depends upon knowing that the rule exists.

Moreover, as mentioned above, this rule may undermine citizens' belief in the legal system as a whole. Setting a default rule that penalizes a party hardly seems like a "fair" default. Citizens may have a hard time grasping the rationale behind this rule; they will only understand that the rule penalizes a party for some ephemeral purpose.

Despite the fact that we worry about this specific proposal, however, there may be value to encouraging this sort of scholarship more generally. The same person who "thought outside of the box" to bring us penalty defaults has also come up with clever and unique answers to other problems. This "practiced creativity" led Ayres to question whether car retailers discriminate (he finds they do[161]) and whether there are discriminatory practices in taxicab tipping.[162] And, his ability to turn questions inside out has led to a rather unique approach to gay rights. Together with Jennifer Brown, Ayres advocates certification marks that employers and businesses can use to designate that they do not discriminate on the basis of sexual orientation.[163] This mark thus allows those citizens who support gay rights to use their market power to enforce equality, rather than trying to use the law to sanction it. [164] So, having rewarded Ayres' creative thinking

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[161] Ian Ayres, *Fair Driving: Gender and Racial Discrimination in Retail Car Negotiations*, 104 HARV. L. REV. 817 (1991); Ian Ayres, *Further Evidence of Discrimination in New Car Negotiations and Estimates of Its Cause*, 94 MICH. L. REV. 109 (1995).

[162] Ian Ayres, Frederick E. Vars, & Nasser Zakariya, *To Insure Prejudice: Racial Disparities in Taxicab Tipping*, 114 YALE L.J. 1613 (2005).

[163] *E.g.*, IAN AYRES AND JENNIFER GERARDA BROWN, STRAIGHTFORWARD: HOW TO MOBILIZE HETEROSEXUAL SUPPORT FOR GAY RIGHTS (2005); Ian Ayres and Jennifer Gerarda Brown, *Mark(et)ing Nondiscrimination: Privatizing ENDA with a Certification Mark*, 104 MICH. L. REV. 1639 (2006)).

[164] Ayres and Brown, *supra* note 163, at 1642 ("The mark provides another way supporters of gay rights can vote with their wallets, rewarding progressive policies and institutions. Just as consumers can travel

in an instance in which his proposal was counterproductive, the scholarship market rewarded creative thinking that led to productive and innovative answers to other policy questions.[165]

Ultimately then, any discussion of what sort of scholarship leads to the greatest welfare maximization must also take into account the broader picture. Though we cannot resolve this empirical question, we certainly believe that those who seek to advance these counterintuitive proposals should be aware of the potential consequences.

Conclusion

In this essay, we have sought to urge legal economists to take fairness concerns seriously. There is robust evidence that individuals have a preference for fair rules. Without taking these strong preferences into account, a legal economist cannot be sure that his proposal is actually welfare-maximizing. Moreover, even if a proposal is discretely maximizing, an unfair rule may do significant damage to the value of the rule of law itself. In the face of this empirical evidence, legal economists, who fail to take fairness preference into account, are ignoring a variable essential to their calculations.

Perhaps the failure to include fairness concerns reflects the legal economists' fear that so doing would be to abdicate their calculators for armchairs. The economist, who seeks empirical data, may find the prospect of navel gazing about fairness to be the antithesis of his discipline. But the legal economist need not fear. Rather, just as the legal economist may wish to empirically discover the best legal rule, he may also

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and spend tourism dollars to support progressive state and local governments, so, too, they can reward companies that treat gay employees fairly, by purchasing their products and services.")

[165] Ayres has even co-authored a book on creative problem solving. BARRY NALEBUFF & IAN AYRES, WHY NOT?: HOW TO USE EVERYDAY INGENUITY TO SOLVE PROBLEMS BIG AND SMALL (2003).

empirically test the strength of individuals' tastes for fairness. Indeed, some studies have found that the citizenry's taste for fairness (or lack thereof) may not coincide with initial expectations.[166] Of course, fairness theorists may be unwilling to concede that fairness is just a taste, but acknowledging that fairness exists will lead to better proposals and more productive scholarship.

[166] Kahneman, Knetch, & Thaler, *supra* note 85, at S295.