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# Does the Chicago School Need to Expand Its Curriculum

Gregory S. Crespi
*Southern Methodist University, Dedman School of Law*

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There is much debate among economists and other social scientists about the merits of the "Chicago School" approach to explaining and assessing the operation of legal regimes and other social institutions. In these debates the Chicago School label is rather indiscriminately applied to a quite diverse group of scholars. There is some justification for the use of this term; the persons so described do generally share certain characteristics. They all apply basic microeconomic principles in a relatively rigorous fashion in their analyses of legal questions, and they use much the same basic descriptive categories, behavioral assumptions, and core normative premises. However, within these general contours of agreement there is still significant diversity of outlook and approach. Moreover, few if any Chicago School scholars resemble in any way the pejorative popular caricature of the zealot analyst who uncritically applies basic price theory to describe and evaluate real-world situations without regard to unique local conditions and complexities and without regard to normative principles other than efficiency.

*Law and Economics: New and Critical Perspectives*, a collection edited by Robin Paul Malloy and Christopher Braun, presents a baker's dozen short

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Gregory S. Crespi is an associate professor of law, Southern Methodist University School of Law.


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articles covering a wide range of topics.[1] There is no single organizing principle that links all the essays included in the volume. Most of them, however, share a common theme of criticism of the Chicago School. The authors each suggest modifications of the Chicago School approach that they argue would make the application of economic principles to legal questions more realistic and more helpful for decision making.

In order to evaluate the merits of these critiques, it will be helpful to begin with a broad outline of the Chicago School approach. I will, of course, have to abstract from much of its complexity and sophistication. It is possible, however, to succinctly convey its core premises, and to make clear its more significant policy implications.

The Chicago School appellation better represents a mood, a disposition, an analytical style than commitment to a dogma. The style is to begin with abstract price-theoretic models based on rational actor behavioral assumptions as first approximations to actual situations, and to reluctantly depart from those limiting assumptions only when the nature of the problem so dictates, and only to the extent required. The disposition is to assess the consequences of policies on the basis of the Kaldor-Hicks efficiency criterion—the aggregated willingness to pay exhibited by the persons affected by the policies, given those persons' current resource entitlements[2]—and to maintain one's allegiance to this normative criterion even when grudgingly accepting the legitimacy of other normative standards under appropriate circumstances.

The Chicago School approach rests on the central premise that all economic actors, whether individuals or other legal entities, can be regarded as if they are engaging in rational maximization of their utility,[3] each acting on the basis of a relatively stable, exogenously determined, internally consistent set of preferences, under the resource and informational constraints that they each face in trying to achieve their objectives. From this crucial starting point the sometimes quite elaborate analyses build in logical fashion.

If, for example, these rational actors are permitted to compete for advantage in market contexts where their property and contractual rights are enforced by the state, and if those markets are characterized by free entry and exit of competitors, sufficiently low information costs and other transaction costs, and internalization of all effects through price signals, then all

1. The essays in the book—titled "Chapters"—are listed in the References. The order that they appear is Robin Paul Malloy, Paul H. Brietzke, Nicholas Mercuro and Steven Medema, Perti Ahonen, Kenneth G. Dau-Schmidt, Ellen Frankel Paul, Jeffrey L. Harrison, Jeff L. Lewin, Daniel H. Cole, Jeffrey Evans Stake, Lawrence E. Mitchell, Thomas S. Ulen, and Christopher Kent Braun.

2. The Kaldor-Hicks criterion is often referred to as the "wealth-maximization" criterion or as the "potential Pareto-improvement" criterion. For a further discussion of the properties of the Kaldor-Hicks criterion, see generally Crespi 1991.

3. Or if the actors are entities rather than individuals, their "profits," broadly defined.

market transactions whose marginal benefits exceed the marginal costs for all the actors involved will necessarily take place. Resources will flow to their highest valued uses through such markets regardless of which actors initially own the entitlements to their use, if there are no significant impediments blocking such market transactions (the principal postulate of the famous Coase Theorem). What will ultimately result from all of this rational, informed competition is an equilibrium that appears to have been arranged by a benevolent "invisible hand"; one that maximizes overall wealth, as measured by the willingness to pay of the affected persons, relative to any other possible form of social organization of their activity.

Within this framework of restrictive behavioral assumptions, it can be demonstrated that the economic role of government most conducive to social wealth maximization is a limited one. The state should provide the security of property and contractual rights preconditions for such market behavior, and correct as unobtrusively as possible for the various forms of market failure that may result when one or more of the other requisites for effective market operation are not met, such as the widespread and low-cost availability of relevant information, the existence of open competition, the internalization of all costs and benefits, etc. To the extent that the government can intervene in social contexts to shape them more in the image of competitive markets, and do so at an acceptably low cost, it will increase aggregate social wealth. Any other form of intervention that hinders market processes will likely impede some mutually beneficial transactions, retarding wealth creation.

This model of human behavior, even if accurate, is incomplete as a source of policy guidance without some normative premises by which to evaluate its predicted consequences. Even if "perfect" markets do serve to maximize aggregate social wealth, this has no necessary relevance for public policy purposes unless such wealth maximization is regarded as a good thing. The other core premise of the Chicago School approach is the normative assertion that such wealth maximization should be the predominant objective of social policy. The consequences of policies are therefore assessed by the Kaldor-Hicks efficiency criterion, which evaluates policies in terms of their impact on aggregate wealth as measured by the willingness to pay of those persons affected, without regard to the distribution of those benefits and costs across the population.

A Chicago School analysis, if it is done without significant departures from these central behavioral and normative assumptions, thus almost inevitably leads to recommendations that accept as foundational the existing distribution of wealth and income, and calls for utilization of actual or simulated market mechanisms rather than authoritarian directives to be used as social coordination mechanisms. This orientation—or bias, if one chooses to so label it—to favor reliance on the invisible hand of market equilibration to coordinate behavior is the main focal point for both criticisms and defenses of the Chicago School approach.

With these preliminary comments in mind, let me now turn to consideration of the merits of *Law and Economics*. The collection seeks to gather in one convenient place relatively nontechnical summaries of some of the more promising recent scholarship carried out at the junction of economic analysis and legal theory. While the book thereby will be of interest to other scholars working in closely related areas, it also will serve well as a supplementary reading for graduate or advanced undergraduate students studying law, economics, or another related discipline.[4]

Most of the authors contributing to *Law and Economics* take issue with some aspect of the basic Chicago School framework described above. They generally call for modifications of the Chicago School approach to incorporate a greater degree of "realism" into its premises, and argue that such refinements would contribute to a more accurate and discerning assessment of when market outcomes are likely to be in accord with fundamental social goals. Stated in sufficiently general terms, such claims are uncontroversial. Few if any Chicago School members would disagree with the proposition that, on occasion, analytical models based on more realistic assumptions will provide better policy guidance. However, many Chicagoans would probably disagree with most of the *Law and Economics* authors whether those authors' proposed analytical departures are likely to lead to more helpful analyses and more discerning normative assessments.

While *Law and Economics* is a valuable contribution to the interdisciplinary literature, the book is not without its shortcomings. It is difficult to mesh harmoniously in a single work the contributions of a disparate group of scholars, each having their own particular research interests, approach, and style of exposition. Works of this genre consequently often suffer from the weaknesses of uneven quality, gaps in coverage, and redundancy. *Law and Economics* unfortunately fares no better than most such efforts in these regards.[5] However, the work as a whole successfully presents and critiques

4. While it is necessary to have some prior exposure to microeconomic theory and legal analysis to benefit fully from the essays, they are accessible not only to law and economics specialists but also to a broad, nonspecialist readership. In general, the contributions make only modest use of mathematical or graphical demonstrations.

Coherent collections of related, nontechnical topical essays such as this book are valuable resources for promoting greater understanding of current controversies among disciplinary specialists. They are particularly helpful as supplementary readings for graduate students working their way toward the current frontiers of inquiry through a primarily technique-oriented course of study. There are too few such integrated collections of accessible readings focusing on the fundamental methodological issues that arise at the interdisciplinary junction of law and economic theory, and *Law and Economics* helps to fill this gap.

5. The opening and closing articles in the book—contributed by the editors themselves—are unfortunately jargon-laden essays of questionable merit. For example, consider this impenetrable prose from Christopher Braun (1995:446) with which he closes his essay:

> The price market mechanism is simply based upon the semiotic proposition of the triadic affiliation of understanding and it is ultimately that triad which underlies any under-

the core principles of Chicago School analysis in a manner that nicely illuminates its contested contours. Moreover, several of the articles were contributed by scholars who have genuinely new insights to share; these contributions are well-written and provocative in their implications.

Three articles in particular—those of Kenneth Dau-Schmidt, Jeffrey Harrison, and Thomas Ulen—each provide excellent summaries of sustained thinking by their authors regarding significant departures from Chicago School assumptions and are worthy of further discussion in this review essay. These three articles focus on aspects of the rational actor behavioral premises of the approach, with Dau-Schmidt subjecting the assumption of exogenous preferences to broad criticism, Harrison calling for recognition of an endogenously generated sense of entitlement, and Ulen questioning the

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> standing of the economic transactions existing in the world around us. As any economic transaction achieves an extant utility, it can also be said that this utility exists solely as the constructed dynamism of the powers of interpretants in relation to observed signified objects.

The opening piece by Robin Paul Malloy (1995:1, 3–4) also tends to obscurity and overstatement, as the following quote suggests:

> Throughout this article, therefore, I will refer to the new law and economics and will mean thereby to refer to my own approach. . . . The new law and economics allows us to deconstruct and reconstruct legal argument in a meaningful way by examining the underlying stories and symbols used to support alternative and competing claims to scarce resources. . . . [T]he discourse of the new law and economics is admittedly subjective. It is contingent and contextual and value laden. . . . From this starting point the new law and economics studies discourse as a market sign; as a temporary and contingent equilibrium of understanding.

Malloy also characterizes the views of Richard Posner in a misleading and mean-spirited fashion which is inappropriate in light of the vast disparity between the extent and significance of the two authors' influence on the field:

> Judge Richard Posner has advocated the acceptability of slavery in modern times; has declared that the poor and feeble minded have no claims to any of society's scarce resources; has treated the presence of Blacks and Jews in a neighborhood as a common nuisance; has asserted that morality is a useless form of conversation and that the Nazi experiments of the Second World War should not be thought of as immoral; and . . . that matters of rape can best be understood in the context of determining the costs and benefits of sex when willing partners are difficult to find or simply unavailable. (P. 22)

The collection is also tainted by the inclusion of a rather opaque piece by Pertti Ahonen (1995) that was apparently intended to communicate some deep insights concerning Finnish university governance. In all fairness to the author, the piece probably reads much better in the original Finnish version. Many of the other pieces included in the collection, while competently presented and of some value to those readers relatively new to the field, are rather pedestrian in their critiques and recommendations.

The collection also suffers from some redundancy. In almost every paper the author takes pains to first outline the general contours of the conventional Chicago School price-theoretic approach to applying economic principles to legal questions that they intend to criticize. While one cannot fault the individual authors for each wanting to properly set the stage for their critiques and proposals, there was apparently insufficient overall editorial control exercised over the early drafting efforts. The result is that the reader is repeatedly subjected to virtually the same summary overview of the Chicago School approach. The standard microeconomic rational actor model with its assumptions about exogenous preferences and informed, utility maximizing choice behavior, the dynamics of free-market equilibration, the basic insights of the Coase Theorem, and the Pareto and Kaldor-Hicks efficiency criteria are explained in simple terms again and again. The redundancy across the articles in this regard can be frustrating if one tries to read more than one or two of them in a single sitting.

assumption of rational behavior. In the remainder of this essay I focus exclusively on these three articles and then close with some general thoughts on the merits of proposals of this nature to modify the Chicago School approach.

Before discussing these articles, let me first be candid about my generally skeptical reaction to proposals that call for significantly broadening the Chicago School framework to make it more "realistic." The potential benefits of such proposals are obvious. The introduction of more realistic and elaborate premises into an analytical framework potentially allow that framework to be applied in a more sensitive and nuanced manner that takes into account contextual factors. Nonetheless, my concern is that when one makes one's model more realistic by introducing more complex premises, one also thereby increases—sometimes dramatically—the problems involved in applying it. The more degrees of freedom in a model, the more parameters that have to be estimated, giving more potential sources of error. Moreover, the number of possible interrelationships that must be precisely specified grows geometrically with the number of parameters involved. The conclusions reached as the model is made more complex become less robust—more sensitive to small variations in the initial parameters—and greater and greater precision in the data inputs is needed to avoid reaching indeterminate conclusions. The result is often an elegant and complex but relatively useless model that cannot produce determinate results unless one has recourse to an often unavailable comprehensive and precise data set.

This problem of unwieldiness is particularly likely to occur when the refinements introduced into a model require the measurement of subjective factors—such as changes in attitudes or limitations on cognitive capabilities—that are inherently difficult to measure and quantify, and to relate to other, more tangible factors in mathematically precise ways. Even Arthur Leff (1974), a stalwart foe of Chicago School thinking who wrote the first powerful critique of Richard Posner's (1974) influential law and economics treatise, conceded that "tunnel vision is the price we pay for avoiding total blindness."[6]

The great comparative advantage of economists is their refined ability to expose and debunk "free lunch" fallacies, identifying and revealing the often substantial hidden costs that accompany the benefits of any action. Economics is often called the "dismal science" because of this constant emphasis of the inevitability of unpleasant trade-offs. This dismality is unfortunately all-pervasive, in that it extends backwards to questions of methodology as well as to the subject matter of the field. In other words, one must confront trade-offs even in how one studies the extent and nature of trade-offs! This constraint places more severe limitations on scholars

6. Leff 1974:477. Richard Posner himself has noted (1992:17) that "complicationism" may ultimately be a more harmful scholarly sin than reductionism.

than is generally appreciated. Any moves toward incorporating greater realism into one's models must yield substantial returns in predictive accuracy or normative power to justify the generally high costs of dealing with the increased data requirements and analytical complexity. Thus, as I assess the Dau-Schmidt, Harrison, and Ulen essays, my focus is on whether their proposals are justified in light of this constraint.

## DAU-SCHMIDT ON ENDOGENOUS PREFERENCES

One of the core premises of Chicago School analysis is that people's preferences are presumed to be exogenous with respect to the legal system. In other words, those preferences are viewed as innate personal characteristics that have a pre-legal, pre-political, acontextual existence, and are not affected by the legal rules that determine people's initial entitlements and govern their conduct. The rankings one assigns to all possible states of the world are assumed to be independent of what one has or can expect to get from that world. The predictive and normative analyses done under this exogenous preference framework focus on the way different legal regimes each translate into a set of price-like constraints on persons seeking to maximize their satisfaction, given those preferences. The allocative effects of different legal regimes are projected, and the welfare consequences for each affected person are calculated on a willingness-to-pay basis for each of the alternative regimes. The willingness-to-pay benefit and cost impacts of each regime are then aggregated to give the net benefit (or net cost) impacts of that regime, and the Kaldor-Hicks criterion is then applied to make comparative efficiency assessments of those legal regimes.

The assumption of exogenous preferences is of course a reductionist and unrealistic premise, given that a number of our more important social institutions are designed largely to alter preferences, not merely to structure the pattern of opportunities. Examples that come readily to mind include such diverse social institutions as families, schools, churches, prisons, and advertising. These institutions often succeed in inculcating unreflective habits of behavior that operate largely independent of price signals and in instilling strong psychological aversions to stigmatized activities. In fact, one could reasonably argue that the diametrically opposed postmodernist assumption—that preferences are not innate at all but are merely socially constructed artifacts imposed upon the blank slates of our minds—would be a more accurate first approximation to reality.

In his essay Kenneth Dau-Schmidt argues that the Chicago School approach would have greater descriptive and predictive power, and its conclusions would have more normative force, if its premises were modified to reflect the fact that preferences are in fact often *endogenous*.[7] He argues that a number of significant bodies of law are intended not merely to facilitate the efficient personal fulfillment of preferences by properly pricing conduct so as to eliminate externalities and other market-distorting factors but also to influence those preferences so as to make persons more inclined to engage in socially desirable conduct. As examples he cites some safety and environmental regulations, antidiscrimination laws, punitive civil remedies, and numerous aspects of the criminal law (p. 154). His point is dramatic: Given the pervasiveness and significance of laws which attempt to—and often do—alter preferences, isn't it unwise to predict and assess their consequences using an analytical framework that assumes away this very possibility?

My first impulse was to agree wholeheartedly. But then I did the dismal thing and considered the trade-offs involved. Dau-Schmidt's burden is to show that the benefits of greater realism are not outweighed by expanded data requirements, added analytical difficulties, or normative assessment complications. On reflection, I am not convinced that he has met that burden.

Economists have generally embraced the exogenous preference assumption and ignored preference-shaping objectives and effects in their analyses. As Dau-Schmidt recognizes (pp. 155–56), this is not because they are unaware that the assumption of exogenous preferences is unrealistic but is primarily because of the tractability concerns noted above. It is much more difficult to formulate a model for predicting the effects of implementing a policy if that model must not only be able to specify the constraints imposed by that policy but must also include a "preference function" that will specify with the necessary mathematical precision the nature and extent of the changes in preferences that will result.

It would be quite a chore to obtain data adequate to establish the parameters of such a preference function, given that the observed responses of persons to any policy will be an intertwined mixture of changes in their preferences and responses to the changed opportunity set. The econometric work necessary to quantitatively separate these sources of response from one another would be a major undertaking. Moreover, the relative significance of preference changes versus opportunity set changes for explaining the consequences of a policy would vary significantly across different kinds of poli-

7. With regard to laws, wrote Dau-Schmidt (1995:153–54), that "are also intended to influence the underlying preferences . . . the traditional economic analysis of law will not give an adequate positive or normative description of the phenomenon . . . the analysis of these laws as preference-shaping policies provides a superior positive and normative description."

Dau-Schmidt's contribution is an edited and generalized version of an earlier, longer article focusing primarily on criminal law questions (Dau-Schmidt 1990). That earlier work was in turn based heavily on seminal writing on endogenous preferences done by Jon Elster and Cass Sunstein, among others. See, e.g., Elster (1983); Sunstein (1986).

cies that would encounter different degrees of resistance from the initial preference structures.[8] It would therefore be difficult to generalize from past experience as to the preference-changing impacts of novel policies. It would require substantial efforts, to say the least, to specify and estimate the parameters of a global preference function that could reasonably accurately take into account the differential impacts on preferences of laws that are of widely varying nature and significance to those persons affected.

Dau-Schmidt recognizes these problems,[9] but he does not address, even in the most general terms, how such a preference function is to be formulated. He focuses instead on convincing the reader that some laws do in fact alter preferences, as well as shape opportunities, and on the important normative issue raised by the specter of endogenous preferences: When, if ever, is it appropriate for the state to attempt to alter preferences?

These are important questions, to be sure, but the argument omits a key step. It is premature to consider how to assess the desirability of preference-changing policies until we first have in place some framework for determining the nature and extent of the preference changes that will result from those policies. If we cannot even predict what changes in preferences will result if we implement a policy, then we are not yet at the point where we need to hammer out normative standards by which we can aggregate and assess its preference-altering consequences. Dau-Schmidt's argument for modifying the Chicago School assumption of exogenous preferences is unconvincing without a demonstration that estimation of a preference function is feasible.

Moreover, even if a preference function can in fact be formulated, the problems for normative assessment are even more severe than those that would arise in the descriptive/predictive context. If one's model assumes that legal changes do *not* have an impact on preferences, the Kaldor-Hicks willingness to pay criterion applied by Chicago School analysts has significant appeal as a normative standard. First of all, unlike more paternalistic measures of social welfare, it respects the widely embraced value of individual autonomy. It does so, moreover, without going to the paralyzing extreme of requiring unanimity as does the Pareto-improvement criterion. Each person's own assessment of the benefits or costs of a policy is used in the calculus, to the extent it is supported by financial capability. The Kaldor-Hicks criterion also has the advantage of yielding assessments that are congruent with the widely shared intuition that aggregate wealth increases are

8. Laws that change what values are taught in elementary schools, for example, might have relatively more impact on preferences and less on opportunity sets than, for example, changes in the level of import duties on textiles.

9. Dau-Schmidt (p. 172) writes: "[I]f one wants to examine the possibility that a policy also affects preferences, one must contend with the problem that any observed influence of the policy might be due to changes in opportunities, preferences, or both. Such simultaneity problems are of course challenging for empirical work."

usually socially beneficial. The criterion is, of course, still subject to strong criticism because of the status quo bias inherent in its "one-dollar, one-vote" referenda, its lack of any concept of "rights," the conceptual problems involved in determining whether to use offer or asking prices for valuation purposes, and certain other, more technical difficulties.[10]

Once one expands the model to include the possibility of preference changes resulting from legal rules, and takes those preference changes into account in any overall normative assessment, the justification for use of the Kaldor-Hicks criterion weakens considerably. To apply the criterion one must first choose whether to measure the willingness-to-pay consequences of a policy on the basis of the affected persons' pre-policy or post-policy preferences. It seems more reasonable to use the post-policy preferences as the valuation baseline, since use of the pre-policy preferences would largely defeat the purpose of allowing for endogenous preferences in the first place. However, it is uncomfortably close to circular reasoning to justify a policy on the basis of its willingness-to-pay consequences if the preferences that generate that expressed willingness to pay are themselves at least partly the creations of that policy. While it is possible that the Kaldor-Hicks criterion so applied would lead to reasonable results under some circumstances,[11] it is easy to imagine other circumstances under which that criterion would endorse outrageous policies that almost no one would approve of in advance of their implementation.[12] The abandonment of the exogenous preferences assumption thus creates complications that would probably require the abandonment of the simple Kaldor-Hicks efficiency criterion and the development of a new standard for normative assessment that was more discerning with regard to the merits of preference changes.

Dau-Schmidt candidly recognizes that the Kaldor-Hicks criterion is poorly suited to serve as a normative standard in an endogenous preferences

10. The literature criticizing the Kaldor-Hicks criterion is voluminous. For one relatively comprehensive critique, see generally Kennedy 1981. See also Calabresi 1991; Crespi 1991:234–37.

11. For example, consider an environmental law requiring polluters to make greater expenditures to avoid emitting airborne pollutants. Such a measure might fail to be a Kaldor-Hicks improvement under the conventional exogenous preferences framework, given the initial preference structure. One of its effects, however, might be to shape preferences so that the public becomes more concerned with clean air and polluters feel more moral opprobrium. Under the endogenous preference framework, a Kaldor-Hicks calculation made on the basis of the new, more pro-environmental preference structure might indicate the law to be an improvement. The latter normative judgment as to the desirability of the law seems at least as reasonably reached as the former, perhaps even more so.

12. As an extreme example, consider a group of persons who each object strenuously to being lobotomized but who after forced lobotomy each express a high degree of satisfaction with their new condition. How many persons would accept as meaningful an endorsement of this measure based on a positive postlobotomy preferences-based Kaldor-Hicks assessment of its consequences?

model, and accepts the necessity of using another criterion.[13] While in his short essay he does not develop a normative criterion suitable for an endogenous preferences model, he does offer some indications as to what properties he would wish such a standard to encompass.

Dau-Schmidt asserts that the costs of preference-shaping policies will generally be higher than the costs of policies that merely alter opportunities, primarily because of other costs he claims are associated with intrusions upon individual autonomy (pp. 156–57). He therefore argues that the state should "reserve preference-shaping policies for cases where the costs of preference shaping are unusually low or the benefits of preference shaping are unusually large" (p. 157). This statement is an implicit endorsement of the cautious use of some sort of aggregative social welfare criterion that nets out costs and benefits—in that way somewhat akin to the Kaldor-Hicks criterion.

However, Dau-Schmidt clearly has some reservations concerning the use of an aggregative normative standard, and seriously engages the quasi-libertarian position that people have a fundamental right to not be subjected to governmental attempts to shape their preferences. While he ultimately rejects that position,[14] he is obviously concerned by the potential for tyranny inherent in governmental efforts to shape the desires of its citizens. He notes the limitations that democratic political institutions and constitutional Bill of Rights protections place on the use of such measures (p. 169), and concludes that given those limitations, an absolute ban on governmental attempts to shape preferences is unwarranted (pp. 168–70). However, he also seeks to develop some additional normative principles of a more "economic" character that might further limit the potential for abusive intrusions on personal autonomy.

Having grudgingly endorsed the concept of a net social benefit measure but having rejected the Kaldor-Hicks willingness-to-pay approach to valuing social benefits and costs as inappropriate in the endogenous preference context, Dau-Schmidt is forced to come up with some other reasonable method of quantifying benefits and costs that shows proper regard for autonomy concerns. At this point the going gets a little tough. The approach he takes is to distinguish between preferences on the basis of how

13. He writes (p. 172 n. 9): "[B]ecause wealth is a concept that depends on the current distribution of preferences and I want to discuss the possibility of legal policies that seek to change that distribution of preferences, I am forced to undertake my analysis in terms of the more subjective philosophical construct 'social welfare.'" He further notes (pp. 172–73 n. 14): "If one wants to evaluate the possible benefits of changes in individual preferences, one has to adopt the more subjective criterion of social welfare maximization."

14. He writes (p. 168): "To some economists, the notion that society might . . . actively seek to promote those favored preferences . . . is an anathema, destined to lead to tyranny. They argue . . . that society must confine itself to merely opportunity-shaping methods of controlling individual behavior. . . . I would argue that it is not . . . necessary for a society to totally abstain from the use of preference shaping in order to avoid a rein of tyranny."

much "society" values their realization, as indicated by the "social welfare function" (p. 158), and then assign values to preference changes that are weighted accordingly. Changes in preferences that are in accord with what society highly values are thus to be given significant weight as benefits, whereas the fact that some people do not want their preferences to be changed will be given little weight as a cost item if those prior preferences are not highly valued by society (p. 158), particularly if those preferences are "invidious preferences" such as the desire to interfere with other persons' freedom (p. 163), or if they arise from a "distortion . . . of self-realization caused by the existing social structure" (p. 169).

Preference-changing policies stemming from widespread "self-paternalism"—seat belt and recycling laws, for example—are to have their impacts highly valued (pp. 161, 169), whereas policies that merely reflect the desire of one group to impose their preferences on another group—motorcycle helmet laws are an example he gives—are to have their benefits more highly discounted (p. 161). The costs of preference-shaping policies will be regarded as low if the preferences to be shaped "are ones that are not strongly identified with self-realization or self-definition" (p. 157) or if the preferences are "sufficiently deviant" (p. 165).

Dau-Schmidt does not address how the benefits and costs of the preference alterations that result from a policy, once estimated through application of the social welfare function, are to be aggregated with the impacts of the changed opportunity set resulting from that policy in order to reach an overall normative assessment. Presumably, once the preference-altering effects of the policy have been calculated, the costs and benefits of the opportunity set impacts are then to be calculated in a conventional Kaldor-Hicks fashion, on the basis of the post-policy preference structures, and then the two sets of effects are to be aggregated into a single bottom-line figure.

It is clear that the normative policy assessment that Dau-Schmidt envisions under his proposed framework will be a rather subjective exercise. The assessment of the value of preference changes would seem to depend almost entirely on what "social welfare function" the analyst uses to determine whether particular changes are to be regarded as costs or benefits and to assign numerical values to these changes. Since there is nothing even remotely approaching consensus concerning the specifications of the social welfare function, that degree of freedom would render highly subjective and controversial any normative assessment carried out in this fashion.

A significant consequence of relaxing the Chicago School assumption of exogenous preferences, therefore, is that even if a preference function can be formulated that is accurate enough to use for predictive purposes, which seems most unlikely, normative evaluation under an endogenous preferences model will necessarily be reduced essentially to advancing one's own subjective assessment of the merits of the policy under consideration. Thus

Dau-Schmidt's proposed technical refinement, which appears at first only to be a fine-tuning of the conventional approach, would actually involve a more radical return to the more subjective and moralistic political economy approach to policy evaluation that was once in fashion, prior to the development of modern microeconomic theory and the Chicago School framework.

The problems with the political economy approach, of course, were that it lacked rigor in its descriptions and predictions and provided no means to command assent to one's normative conclusions from persons who did not agree with the many value judgments one had made along the way. This lack of rigor and authoritativeness was exactly the problem that the scholars who developed the Chicago School approach were trying to finesse with their more narrow, reductionist approach and with their more "objective" willingness-to-pay–based normative criterion. Dau-Schmidt is therefore taking a major step by suggesting that the exogenous preference assumption be relaxed. His essay is very thought-provoking, but raises more questions than it answers. To the extent that his objective is to convince the reader that this refinement will expand the power and usefulness of Chicago School analysis, he is unconvincing. The changes in the approach that refinement would necessitate would be so far-reaching that they would alter its character entirely. For better or worse, discarding the exogenous preferences assumption is tantamount to repudiating the Chicago School approach entirely and returning to an earlier mode of policy debate.[15]

## HARRISON ON INCORPORATING THE SENSE OF ENTITLEMENT

The short piece contributed to *Law and Economics* by Jeffrey Harrison[16] also calls for departure from the Chicago School assumption of exogenous preferences. However, Harrison's proposal, which calls for incorporating a sense of entitlement into the framework, is a much more limited extension of the Chicago School approach than Dau-Schmidt's.

Harrison's argument develops three major points. The first is that people not only have preferences regarding what goods and services they would like to obtain but also have a "sense of entitlement" that the exchanges that they enter into as a means of moving to higher levels of satisfaction should be "fair." Moreover, people will regard themselves as having been treated

15. Such a change has much to be said for it, some of which I have tried to communicate in my earlier writings. See Crespi 1991. But I believe that such a major change, if it is to be made, should be done so directly and straightforwardly, rather than indirectly and perhaps inadvertently through tinkering with the Chicago School framework.

16. Harrison's contribution is an abridged version of a much longer article, "Class, Personality, Contract, and Unconscionability," that appeared in 1994 in *William and Mary Law Review*.

fairly only if they obtain at least what they perceive to be their proper share of the gains from trade. They may even refuse to enter into a seemingly mutually beneficial transaction if they feel that the division of gains is sufficiently unfair.

Harrison's second point is that a person's sense of what constitutes a "fair" division of the gains from exchange is not an innate, exogenous preference but is instead endogenously determined by the legal and social order, with one's social class being a particularly significant determinant of one's sense of entitlement (p. 222). Persons from higher social classes will generally have a stronger sense of entitlement and, consequently, will insist that they receive a larger share of the net gains from a transaction.

His final point is that the Chicago School model should be modified to take into account this endogenous "sense of entitlement." He argues that such a move toward greater realism would have several important ramifications. First, the resulting framework would be less likely to overstate the number of otherwise Pareto-efficient transactions that will occur under various legal regimes, since the models would take into account the fact that some people will choose to forgo seemingly mutually beneficial transactions because of the perceived unfairness of the associated division of gains. Second, recognizing the operation of this endogenous preference would enable analysts to better predict how the parties to exchanges will divide the gains from trade and thus more accurately predict the resource allocation consequences of policies.

The final, and most significant, consequence would be to clarify that the seemingly uncontroversial Pareto-efficiency criterion is in fact a very "thin" normative standard that overlooks much of significance (p. 231). Some Pareto-efficient transactions occur only because one of the parties is willing to accept a very disadvantageous division of the gains from trade. These persons do so, Harrison argues, because they have been socialized by the experience of relative deprivation to have a very weak sense of entitlement. These transactions therefore may lack the moral legitimacy to be properly enforced by contract law (p. 237). Incorporation of the sense of entitlement into normative assessment would thus have significant and critical implications for the evaluation of current contract law doctrines that favor enforcement of "consensual" transactions without regard to whether they occur between persons of different social classes (pp. 230–31, 237–39).

Does there really exist a class-dependent sense of entitlement? In his effort to convince, Harrison draws on two separate bodies of theoretical work that have recently been developed: equity theory and relative deprivation theory.[17] Equity theory rests on the general proposition that people regard transactions as fair when each person's share of the gains is perceived to be proportional to what he/she has contributed to the transaction (pp.

17. See Harrison (1995:224–29) and the sources cited therein.

224–25). Harrison argues that persons of higher social class regard more aspects of their educational and other background as constituting inputs they have contributed, thus justifying a relatively larger share of the returns (ibid.). Relative deprivation theory is based on the idea that when people judge whether they are being accorded fair treatment, they tend to make their comparisons with persons of similar social class rather than with a more generic average (p. 225).

Harrison claims that there is sufficient empirical evidence to demonstrate the existence of the sense of entitlement. He then presents a graphical Edgeworth Box model to explain how the sense of entitlement exhibited by one or both parties to a potential exchange will limit the range of mutually acceptable terms of trade. He also notes that the sense of entitlement that limits that range could alternatively be regarded not as a preference, but instead as a party-specific "transaction cost" that could block some otherwise Pareto-efficient exchanges (p. 237).

In Harrison's view, regardless of what underlying psychological and sociological theories are used to explain the phenomenon of a class-based sense of entitlement, the implication of that phenomena is that relatively disadvantaged persons will come to accept conventional divisions of the gains from trade as fair, as opposed to aspiring to some more favorable allocation (p. 227). Traditional splits tend to become endowed with normative significance. This phenomenon thus tends to legitimize and sustain existing patterns of social and economic stratification. By incorporating this phenomenon into our descriptive and normative models, he concludes, we are therefore less likely to accept uncritically measures that will allow the more well-off to exploit the less fortunate under the cover of "consensual" market transactions (pp. 237–39).

This insightful and disturbing essay reveals a significant shortcoming of the Chicago School approach. People often do adjust their expectations in some fashion to conform to their lot in life, so as to reduce their sense of deprivation and discomfort, and the use of analytical models that ignore this fact may lead to misleading conclusions. A scholar who engages in Chicago School-style analyses of policy proposals will, after reading this essay, certainly be more aware that his exogenous preference models overlook a significant impediment to certain classes of transactions and ignore a crucial social factor relevant to determining the division of the gains from trade. He will also be less likely to uncritically endorse Pareto-efficient transactions and more inclined to consider the nature and sources of the motivations of the participants to those transactions.

However, while Harrison's cautions provide important caveats for use of the model, it is not clear that this endogenous sense of entitlement can be formally incorporated into the Chicago School framework without creating insuperable analytical difficulties. If it could be done, there would be obvious benefits. One could then assess precisely the extent to which the sense of entitlement is impeding exchange and rigorously take into account the sense-of-entitlement-altering aspects of policies that cause changes in the social class structure. To do so, however, one would have to include an equation that would specify each person's sense of entitlement as a function of the overall distribution of entitlements. While this would not have to be the full-blown "preference function" that Dau-Schmidt's proposal of abandoning the exogenous preference assumption would require, it would still entail a herculean (and probably futile) effort. Harrison himself recognizes that while the equity and relative deprivation theory arguments have intuitive appeal, they have not yet been developed to the extent which would allow for precise prediction and analysis (pp. 226–27).

Overall, Harrison has made an excellent point on how the attitudes of economic actors are shaped by their social position, and he has provocatively drawn out the implications of that insight. His concerns should be kept in mind by all persons engaged in Chicago School analyses, to avoid the risk of uncritically endorsing Pareto improvements that conceal lurking inequities. His insight is not, however, easily amenable to formal incorporation into conventional analytic models. The allowance of an assumption of endogeneity for even a very limited set of preferences is just too unruly to harness in rigorous fashion within the Chicago School framework.

## ULEN ON RECOGNIZING COGNITIVE LIMITATIONS

Thomas Ulen considers in the tort law context the implications of relaxing another central assumption of Chicago School analysis: the assumption that potential tortfeasors and victims will act in a rational fashion.[18] He begins by outlining at some length—and in a relatively more technical style than that adopted by the other contributors to the book—the conventional Chicago School framework used for the economic analysis of tort law. That framework is based on a view of tort law as primarily a vehicle for minimizing the total social costs of accidents and accident prevention, through the creation of incentives that internalize all costs, in a context where consensual pre-accident allocation is not possible (pp. 388–89). Ulen makes clear that this framework rests on a number of simplifying assumptions. Most significantly, potential tortfeasors and victims are assumed to have stable, transitive preferences, be reasonably well informed, and respond rationally to any incentives provided (p. 389). The model further assumes that litigation is costless, the courts are infallible, there exists no possibility to shift liability through insurance, and that no other social policies exist that

18. Ulen's essay is essentially an abridged version of some earlier work he has done (1989) concerning the significance of cognitive limitations for the economic analysis of law.

would internalize the costs of accidents (pp. 389–90). Under these severe simplifying assumptions, various regimes of liability such as negligence, strict liability, or comparative and contributory negligence, can be assessed for their relative efficiency through application of the Kaldor-Hicks normative criterion to their effects.

Ulen takes the reader through a relatively complex and sophisticated review of the main conclusions reached through this conventional Chicago School assessment, which can be summarized as follows. First, a negligence standard that defines reasonable behavior as taking all cost-justified precautions will provide the efficient incentives for all potential tortfeasors (pp. 399–400) and for all potential victims (p. 402). Second, a strict liability standard will, somewhat counterintuitively, provide the same efficient incentives for potential tortfeasors, although it will not induce an efficient level of precaution by potential victims (p. 404). Therefore, a negligence standard that uses a definition of reasonableness based on cost-justified precautions will create more efficient incentives than would a strict liability regime for persons to take due care, except under unusual circumstances where there is nothing potential victims can do to lessen the possibility or severity of injury (p. 406). In those latter circumstances the efficiency of the two standards would be the same.

Ulen next turns to his main concern: the implications of relaxing the assumption of rational behavior. He begins by defining rationality as meaning that one has transitive preferences.[19] He notes that economists have been reluctant to abandon the assumption of rationality, partly for the reasons of analytical tractability discussed at length above but also because most deviations from the predictions of price theory can be explained without having to postulate irrationality (pp. 411–12). However, he is aware that much recent scholarship by cognitive psychologists and economists has produced results that are difficult to reconcile with this assumption,[20] and he is apparently concerned about work suggesting that people do not act rationally when making decisions under conditions of uncertainty.

Ulen concludes that the evidence supports the argument that many people do have cognitive limitations that cause them to depart from strict rationality in several relatively predictable ways. First of all, they have difficulty dealing rationally with low-probability events and do not always price these events through a rational application of expected-value and risk analysis techniques.[21] They commonly overvalue moderately low-probability

19. A person is said to have transitive preferences if, when he prefers a bundle of goods A to a different bundle B, and prefers bundle B to bundle C, then he will necessarily prefer bundle A to bundle C. Ulen, p. 411.

20. Ulen, pp. 412–13. See also Tversky, Slovic, and Kahneman 1990.

21. One of the most interesting findings of recent experimental work on the psychology of choice under uncertainty is that people will under certain circumstances say that they would be willing to pay more for the opportunity to take gamble A than to take gamble B,

events, while undervaluing or ignoring completely very low-probability outcomes. Second, they have difficulty dealing with problems that involve intertemporal choice and at times behave in ways that imply very high discount rates that are inconsistent with those implicit in some of their other actions (pp. 416–17). Finally, they often ascribe a higher value to a good they own than they would to the same good if they did not own it and had to purchase it (pp. 413–18).

If this sort of seemingly irrational choice behavior is in fact widespread, what consequences should that have for the economic analysis of tort law? Clearly, if people are not responding rationally to the incentives created by the tort law regime, then a regime that presupposes rationality is unlikely to achieve its desired objectives. In particular, Ulen argues, if potential tortfeasors or victims must engage in complicated probability calculations to determine their optimal conduct, they are quite likely to behave in an inefficient fashion. As a result, it may be more efficient to impose a simple, bright-line rule of liability, even if it is not perfectly tailored to the situation of each affected person, to obviate the need for such calculations. Ulen also makes the more subtle point that if there are general differences in the degree of cognitive capability between potential tortfeasors and potential victims for various kinds of accidents, this would have a bearing on the relative efficiency of negligence and strict liability regimes governing those contexts.

The recognition of significant and widespread cognitive limitations as a factor to be considered in designing tort laws could have major implications for governmental efforts to regulate risk. A Chicago School analysis would suggest that if all costs are internalized, all that is necessary to achieve efficiency is perfect information. However, if people are processing information in an irrational fashion, this conclusion will not hold. Rather than attempt to assure dissemination of the information needed to facilitate accurate risk assessment, it may then be more efficient for governments to impose clear standards of conduct that are congruent with the behaviors most persons would choose if they acted rationally.

If, as an example that Ulen gives, motorcyclists systematically underestimate the benefits of wearing helmets, it may be more efficient to mandate helmet-wearing than to attempt to provide cyclists with better information about safety risks. Many other examples come easily to mind. If cognitive limitations are widespread and significant in magnitude, efficiency would

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when gamble A has the higher expected value but then, if told to assume that they own those gambles and are to price them for sale, will seeming reverse themselves and place a higher price on gamble B than gamble A. Ulen, pp. 413–44. This behavior could be explained as a case of intransitive preferences or, instead, as an instance where the behavior demonstrated is not "procedure invariant;" i.e., is affected by the procedure used to measure it (p. 414). Ulen cites approvingly a recent influential article that concludes that this behavior is best explained by the latter hypothesis (p. 415).

perhaps be better served by moving to a simpler and more paternalistic set of tort laws that relied less on rational individual judgment.

Ulen has made a valuable contribution to the literature by grappling with the implications of the increasingly strong body of evidence that suggests that people often do not behave in rational fashion. He has made clear that there is increasing reason to be suspicious of the conclusions of Chicago School analyses of tort law efficiency that presuppose universal rationality. He has also demonstrated that allowing for the existence of cognitive limitations can have considerable implications for the design of efficient tort rules.

Ulen fully recognizes, however, that the study of cognitive limitations is in its very early stages. He concedes that considerably more research is needed to establish who suffers from these limitations, and to what extent and under what circumstances, before the rationality assumption of the Chicago School framework can be relaxed in a formal manner that would allow for the making of falsifiable explanations and predictions. He admits that these are "daunting questions" but concludes that "they must be answered if the economic analysis of tort law is to advance" (p. 423) Even if one is not willing to go quite as far as Ulen does in assessing the significance of cognitive limitations research for the future of economic analysis, one must concede that it is an important intellectual frontier that merits further inquiry.

## CONCLUSION

*Law and Economics* nicely illuminates the potentially adverse implications of some of the central restrictive assumptions of the conventional Chicago School approach to the economic analysis of law, and in so doing it provides a needed balance to the extreme emphasis on the formal, mathematical techniques of Chicago School analysis that currently characterizes much literature and graduate education in that field. While it is somewhat uneven in the quality of its contributions, and prone to redundancy across the articles, it includes several insightful essays, especially those of Kenneth Dau-Schmidt, Jeffrey Harrison, and Thomas Ulen. However, none of these three writers succeeds in proposing an adequate replacement for the particular assumption that they call into question. To broaden the premises of the Chicago School framework to allow for the endogeniety of preferences, a widespread sense of entitlement, or pervasive cognitive limitations would likely complicate the resulting analyses to the point where no definitive conclusions could be reached on any significant issue. This would virtually be tantamount to discarding the Chicago School framework altogether, which seems premature given the lack of alternative explanatory models of comparable scope and power.

Despite their failure to propose adequate solutions to the analytical problems of the Chicago School framework that they so clearly identify, the Dau-Schmidt, Harrison, and Ulen essays nevertheless each provide extremely valuable background and cautionary advice for those persons who must perform or use the results of such analyses. These provocative articles alone justify the book's publication and mark it as a valuable contribution to interdisciplinary scholarship.

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