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Gregory S. Crespi

Southern Methodist University, Dedman School of Law

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Putting the Chicago School Debate in Proper Perspective

Gregory S. Crespi

Let me first of all thank Professors Dau-Schmidt (1997), Harrison (1997), and Ulen (1997) for responding to my review essay set forth earlier in this symposium that assesses their contributions to Malloy and Braun's *Law and Economics: New and Critical Perspectives* (1995). The Review Section Editor has generously accorded me the privilege of having the last word in the debate here presented. However, I hope—and expect—that the discussions among social scientists and legal scholars concerning the merits of Chicago School-style thinking will continue unabated, and perhaps even be further encouraged by this symposium. In this brief closing essay I will first address the specific claims and criticisms made by each of these three authors. I will then offer a few final comments about the larger debate concerning the merits of the Chicago School approach.

A Response to Dau-Schmidt

Dau-Schmidt in his response (1997) goes directly to the heart of the controversy surrounding the Chicago School approach. This approach is without question based upon very restrictive assumptions, including the assumption of exogenous preferences. As he well points out, an explanatory framework that begins with this assumption is inherently incapable of assessing specific laws or broader institutional arrangements that are partly or wholly designed precisely to alter preferences.

Unfortunately, if the exogenous preferences assumption is relaxed, the Chicago School models will no longer be able to provide determinate predictions, since we are as yet unable to formulate precisely when and to what extent our policies will impact preferences. Moreover, as Dau-Schmidt recognizes, the conventional efficiency criteria lose their relevance if it is rec-

ognized that preferences are altered, and so it would be necessary to develop new and more subjective criteria for normative assessment in an endogenous preference framework.

We face a difficult choice. We can continue to use restrictive Chicago School models which obscure several crucial questions raised by the fact that many policies do alter preferences: Which preferences should be favored? Which preferences should be disfavored? And what is the appropriate role of the state in shaping individual preferences? Or we can relax the assumptions of our models to allow for endogenous preferences but then find that we are unable either to predict or evaluate the results of our policies. Do we prefer tunnel vision or total blindness (Leff 1974:477)?

Dau-Schmidt opts for more realistic assumptions and regards the benefits of having more complete and realistic Chicago School models as outweighing the costs of their resulting tendency toward indeterminacy and normative complications. I disagree. I argued in my essay that the conventional Chicago School models, while severely limited in the kinds of information they can encompass, are exactly for that reason useful analytical tools. Because of their sharply circumscribed nature they facilitate a precise identification and tracing of certain kinds of consequences that may result from implementing policies under a fairly broad range of circumstances. They thus have an important role to play in supplementing less constrained analytical approaches.

We should recognize that the Chicago School framework, while inherently limited, is nevertheless a helpful analytical tool whose utility would be diminished if its premises were made too realistic. The most productive role that insightful reformers like Dau-Schmidt can play is to take up the challenge of building a more comprehensive and realistic alternative explanatory model of human behavior from the ground up, perhaps along the lines of the underappreciated Austrian tradition which emphasizes the endogeneity of social institutions and the malleability of preferences.¹

A Response to Harrison

In my essay I conceded Harrison's point (1997) that the "sense of entitlement" considerations he described in his contribution to *Law and Economics* probably cannot be incorporated into the Chicago School framework without destroying its usefulness. In his response, he now goes further and argues that the Chicago School framework is inadequate to address *any* issue that calls into question a restrictive assumption of the model, because "the system itself is a closed one" (p. 186).

1. For an excellent introduction to the Austrian economic tradition, and a comprehensive bibliography of work done in that tradition, see generally Vaughn 1994.

I disagree with that broader claim. The Chicago School framework is a human creation, and is only as closed as we want to make it. If we choose to relax its assumptions to allow for endogenous preferences, as Dau-Schmidt recommends, or to allow for cognitive limitations, as Ulen recommends, or to allow for the “sense of entitlement” Harrison describes, we can certainly do so. The issue is not whether we can change the assumptions of the Chicago School models; it is instead whether the benefits of doing so justify the analytical complexity and indeterminacy costs I have identified and discussed.

The Chicago School framework is robust enough to tolerate some minor modifications of its assumptions where observed behavior appears to depart in minor and relatively predictable ways from behavior that is generally assumed to occur. However, I again agree with Harrison that there is probably no way to incorporate as dramatic a departure from the exogenous preferences assumption as his “sense of entitlement” and the associated normative judgments concerning the effects of various forms of socialization on attitudes. If not, then an alternative explanatory and normative paradigm is needed to deal with such concerns, and Harrison’s prior work has indeed made a contribution toward the articulation of such an alternative. However, the fact that the Chicago School framework cannot adequately address issues that sharply challenge some of its restrictive assumptions does not necessarily mean that it cannot provide useful guidance concerning other issues that do not raise those concerns, or raise them only tangentially. I feel that his sweeping rejection of Chicago School analysis as useless for the development of legal theory² ignores the many valuable insights that have been derived from that framework.

A Response to Ulen

Ulen’s contribution (1995) to *Law and Economics* examined the implications of relaxing the rational actor premises of Chicago School models to better incorporate recent findings concerning cognitive limitations, and argued that this would be a positive step. In my essay I agreed with this view but noted that this new thinking has not yet been formalized to the extent that it can be easily meshed into the mathematical formulations used for Chicago School analysis.

In his response Ulen (1997) has discussed more extensively his views concerning the normative wealth-maximization criterion used by Chicago School analysts. He also criticizes a couple of statements I have made in my

2. Harrison (1997:185) says that suggesting “that the Chicago School is the relevant paradigm slants the analysis, determines the answer, and retards useful development of legal theory.”

essay. Let me first point out several difficulties I have with his discussion of the wealth-maximization criterion and his application of that criterion to an educational policy issue, and then respond directly to his specific criticisms.

Ulen draws a distinction between the Kaldor-Hicks criterion—which ideally incorporates all of the benefits and costs of a measure—and the wealth-maximization criterion, which Ulen states “counts only actual market values in computing the benefits and costs of a change . . . [and] ignores nonpecuniary values, including those of nontraded goods and services, such as some environmental amenities and the income and wealth distribution” (p. 003). This statement strikes me as incorrect on two counts. First, the benefits and costs of a change are properly calculated for Kaldor-Hicks or wealth-maximization purposes from the resulting consumer and producer surplus changes, as revealed by the expressed willingness to pay by those affected, and not by the “market values”³ of the goods and services involved, which reflect the valuations at the margin of market trading rather than the specific impacts on those affected by the change.⁴

In addition, it is simply not the case that when economists apply the wealth-maximization criterion to assess a policy measure, they confine themselves to impacts involving market-traded goods and services and ignore nonpecuniary and external effects. The wealth-maximization criterion is generally regarded by law and economics scholars as exactly equivalent to the Kaldor-Hicks criterion,⁵ and for either criterion the analyst should attempt to include and value *all* impacts of a policy, including its external environmental impacts and any resulting subjective satisfaction or dissatisfaction with its wealth-distribution consequences.

With regard to Ulen’s human capital creation example (p. 004), a Chicago School analyst engaged in a wealth-maximization calculation would likely consider and attempt to value the more diffuse nonmarket impacts of that policy, including the social benefits of allowing the least fortunate members of society to participate more fully in its productive life, since as recognized by Ulen this is to some persons an important consideration. Only a very bad or disingenuous Chicago School analyst would ignore this factor. However, a competent analyst should *also* consider the deadweight wealth losses resulting from the significant disincentives for productive activity that would be created by the increase in marginal tax rates needed to

3. I assume that by this term Ulen means the equilibrium market prices of the goods or services after the policy at issue has been implemented.

4. Posner 1992:16. For example, the effect of a policy measure that provides someone with an additional widgeit that he would be willing to pay up to \$100 for, if he had to, is properly valued at \$100 for Kaldor-Hicks or wealth-maximization calculations, even if he can purchase that new widgeit in the market for \$50 after the policy measure is in place.

5. “The Kaldor-Hicks test is fully equivalent to the principle of wealth maximization, and . . . [Richard] Posner explicitly recognizes their identity.” Kronman 1980:236.

finance Ulen's proposed \$1.66 trillion investment, an impact that Ulen unfortunately neglects to mention in his example.

It is true, as Ulen states, that the benefit and cost assessments made in a wealth-maximization calculation are based on willingness to pay, which is to a great extent a function of initial wealth endowments. One may be critical of the Kaldor-Hicks and wealth-maximization criteria on that score, as I have been in some of my earlier writings (see, e.g., Crespi 1992:235–37). I would certainly agree with Ulen that the Kaldor-Hicks criterion is best viewed as merely providing a starting point for the evaluation of social changes.

Let me call attention to two places in his response where I believe Ulen has somewhat misunderstood my arguments. First, I stated that Chicago School analysts should “accept as foundational the existing distribution of wealth and income” (Crespi 1997:151). By the term “foundational” I meant only that they should use existing wealth endowments as the basis for measuring willingness to pay, *not* that they should regard that distribution as somehow inviolate and outside the realm of debate as Ulen understands my statement. If application of the Kaldor-Hicks criterion leads to the conclusion that the benefits of a nonmarket redistribution of income or wealth exceed its costs, then that criterion would endorse such a redistribution, despite that original distribution having been the “foundation” of the calculations. I also did not intend to imply that use of existing wealth endowments as a foundation for efficiency calculations meant that nonpecuniary impacts were to be overlooked, as Ulen (1997:193) suggests.

Finally, I do not feel that I was being “highly skeptical, almost nihilistic” (p. 197) when I argued that introducing more realistic assumptions into an explanatory framework can easily render the models so complex and unwieldy as to be practically useless. I did not intend to suggest that this insight means that we necessarily must continue to make do with our current, flawed models. I simply meant that we must think like economists here and weigh the trade-offs involved when we consider introducing more realistic and complex premises. There may well be some modifications of Chicago School premises that can provide sufficient additional explanatory power to justify the increased analytical complexity. However, most proposed modifications would entail more added complexity than can be justified by their advantages. We indeed have made progress in understanding legal rules and institutions as a result of the past 25 years of law and economics scholarship, as Ulen notes (p. 197). This progress may, however, be due more to some scholars stubbornly adhering to simple Chicago School premises, and playing out their implications in a wide variety of contexts, than to the willingness of other scholars to abandon those premises when their limitations become apparent.

Conclusion

Even the most stalwart adherents of Chicago School analysis concede that it rests on a set of radically simplified assumptions about human preferences, knowledge, cognitive skills, and the like. However, largely because of these drastic simplifications, the framework is analytically tractable and permits detailed and precise investigation of complex causal chains of behavior. Only a very modest additional dose of "realism" can be tolerated in such a theoretical system before its advantages are lost in a blur of increased complexity and indeterminateness.

I generally agree with Dau-Schmidt, Harrison, and Ulen that the preference-shaping aspects of the law, the differing senses of entitlement that various groups of persons are socialized to accept, and human cognitive limitations are each too significant a factor to be overlooked in social policy analysis. The Chicago School framework is indeed an inadequate vehicle for understanding and evaluating laws and other social institutions that directly implicate those concerns. I believe, however, that it is probably impossible to broaden that framework sufficiently to adequately address those concerns without destroying its usefulness altogether.

Rather than attempt to radically modify the premises of Chicago School analysis, as Dau-Schmidt and Ulen suggest is the appropriate tact, I would join with Harrison in calling for the development of an alternative explanatory and normative paradigm that is not based on Chicago School premises. As I have noted above, the Austrian economic literature might provide the basis for developing an approach that can better address the endogeneity and cognitive limitations concerns (Vaughn 1994). However, persons doing such innovative theoretical work should continue to respect and appreciate Chicago School analysis for its rigor and for the often counterintuitive insights it can provide when applied in situations that correspond in rough fashion to the assumptions underlying that approach.

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