

Lecture Three:

Advanced Civil Law

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Rome, March 2016

American Law in a Global Context

Law and Economics

Economic Efficiency

Traditional ideas of justice and morality in the law now face a radical challenge from economists and economically trained lawyers. Every good law school faculty now includes at least one scholar trained in a field called "law & economics" (L&E, for short).¹ A novel form of interdisciplinary research has become a movement. In some areas, such as antitrust and unfair competition law, economic understanding is indispensable. But the devotees of L&E make their most challenging contributions in other fields of law where economics has had, until recently, no apparent bearing. The battleground for this new way of thinking about law has been torts or accident law.

The insight that initiated this challenge was Yale law professor Guido Calabresi's reconceptualization of the field of accident law and its goals. He began by noting that both accidents and accident prevention generate costs that can be measured in a single common denomination of dollars

This chapter is excerpted from George P. Fletcher, *Basic Concepts of Legal Thought* (New York: Oxford University Press, 1990).

¹ For general treatment of the field, see Richard Posner, *Economic Analysis of the Law* (3d ed.) (Boston: Little, Brown, 1986).

and cents.² Accidents cost money, as reflected in the dollar sign that juries place on the victims' physical and emotional harm, medical bills, lost wages, and pain and suffering. Accident prevention also costs money—the funds expended, for example, on making cars, airplanes, and microwave ovens safer. These, plus the costs of administering the legal system, constitute the total costs of accidents. The aim of tort law, Calabresi inferred, should be to minimize the sum of these costs. As expressed in economic language, the goal of tort law should be to bring about an optimum number of accidents. This optimum is reached at the equilibrium point where the marginal cost of one more accident exactly equals the marginal cost of preventing that accident. An optimum number of accidents is also considered the efficient solution to the accident problem.

These terms *optimum* and *efficient* are now common parlance in American law. The courts have yet to go over to the new language, but there are many teachers of law who think that efficiency is the *summum bonum*, the supreme good, of legal arrangements. Though they are loath to identify their theories as "normative" as opposed to "positive" and scientific, the advocates of efficiency espouse a new morality for the lawyer—at least, a new mode of expressing the principles of utilitarian morality.

The quest for efficiency has led to efforts to restructure, or at least reinterpret, the traditional criteria for making one person pay for harm caused to another. Submerged in this search for efficiency is the recognition that economics itself contains diverse schools of thought. There is far more conflict and contradiction in economic theory than the advocates of L&E are willing to concede. Explicating this conflict of ideas is the task of this chapter.

Voluntary Markets and Pareto Efficiency

Efficiency—like so many of the terms we have considered in this book—signifies different things to different people. One influential notion of efficiency derives from the ideal of trading in a frictionless market. Let us

² See Guido Calabresi, *The Cost of Accidents: A Legal and Economic Analysis* (New Haven, CT: Yale University Press, 1970).

take a closer look at the meaning of allocating goods and services efficiently.

Imagine that the goods of society are distributed to the members of society in a more or less equal way. Yet the goods are different. Some people have television sets, others have shoes, others have sugar, and still others, tobacco. As life begins in this imaginary society, the players realize that they have different goods. The one with shoes realizes that he would like a TV set, and the possessor of the TV's senses immediately that she would like some shoes. The two of them consider a trade and begin negotiating. Eventually they agree on a "price" for the TV set in the currency of shoes, say, five pairs of shoes for one nineteen-inch color set. The two parties exchange the goods. The exchange is based on consent, freely given, informed by knowledge of all the available alternatives.

Now what do we want to say about the effects of this exchange on the welfare of these parties? Have they merely exchanged an "equal" amount of goods, leaving them in exactly the same situation they were in before the exchange? Or are they, as a result of the trade, better off, happier in some sense? Recall Aristotle's view that the exchange is a form of commutative justice: The traded goods are equal in value, and therefore no one is better or worse off as a result of the exchange. Modern economic theory departs radically from this premise of equality in the exchange. The guiding assumption today is that both sides benefit from the exchange. If they would not benefit, economists now say, they would have no incentive for making the trade. The party who gets the shoes values five pairs of shoes more than she values a television set. The party who gets the TV set prefers it to five pairs of shoes. Both parties, therefore, are better off. Their "utilities," viewed subjectively, are enhanced.

The trade makes the world better off, insofar as it makes at least one of the parties better off and it makes no one worse off. This is the definition of a *Pareto-superior move*, a trade that benefits at least one side and harms no one. Our trade of a TV set for shoes was a Pareto-superior move for both sides. Note that in the economic view of the world, if parties have the same stack of goods in front of them, trade occurs only because the trading partners have different sets of preferences. They are individuals, with different tastes and desires. If everyone were alike, if we all valued shoes and TV sets in exactly the same way, there would no incentive for trade. There would be no point to trading goods if we did

not gain something. The economist begins by noting that trade does in fact take place in the real world. His theory of Pareto-superior moves explains what we observe in the marketplace.

Now note what happens when the possessor of tobacco wants to trade his stock for a TV set. He goes to a TV owner and offers her an amount of tobacco. She responds that she despises tobacco and that, in fact, you would have to pay her to take it. What should the tobacco holder do? He has two ways of obtaining a TV set: He can search around for other parties who are willing to trade something for tobacco (shoes will work, or possibly sugar) that he can use to entice the TV holder into selling a TV set, or he can wait until someone who likes tobacco comes into possession of a TV set. The world would be much simpler for the tobacco holder if everyone used an intermediate, common commodity that everyone liked. That common denominator is money. If they had a common currency—say, dollars—everyone would trade first for dollars and then use the dollars to buy what they really wanted.

The assumptions that underlie this simple version of a market are very important. First, everyone participates with an initial set of property rights. They could not trade if they were uncertain about what they owned. Second, each of them is an idiosyncratic individual, each having different tastes and preferences. And third, each is capable of consenting to voluntary transfers that will transplant their property rights to others. The first and third assumptions illustrate how the market and the legal system interact. Without a legal regime specifying who owns what and a system for transferring rights, the market could not operate. Without these basic rights firmly secured, there can be no market. This principle is becoming clear to Eastern Europeans who are struggling to make the transition from a Communist order in which the state owned almost everything to a market economy based on private ownership.

Sooner or later the market transactions in our imaginary society of shoes and TV sets will come to an end. When they do—that is, when there is no longer the possibility of making a Pareto-superior move—the resulting equilibrium is called a Pareto-optimal state. This is the optimal point beyond which trading cannot improve the welfare of these two participants. Trading ceases until either new goods are brought into the game or the preferences of one of the parties suddenly change and thus create the possibility of a new Pareto-superior transaction.

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avowed ignorance. As a matter of principle, economists claim that there is nothing to know economically about the relative merits of different Pareto-optimal states. The Pareto-optimal state might be a roughly equal distribution, or it might be a situation in which one player possesses all the goods; in neither case would a move be possible that would not leave someone worse off. All of these Pareto-optimal states are equally efficient in the sense that no readjustment of the goods can bring about a better state of affairs. Optimality or efficiency in this economic sense has nothing to do with the justice or desirability of the distribution.

Another point of avowed ignorance is the quantitative extent of the gain that occurs from each trade. We know that when the shoe holder and the TV possessor trade, both make themselves better off, but we do not know how much better off each becomes. Nor can we say whether one gains more than the other. The reason for this limitation is that utility in economics is entirely subjective. It depends on how much individuals are actually willing to pay for the goods they want. The precise way of stating this assumption is: *no interpersonal comparison of utilities*. The most we can do is derive a map of utilities for each person, and that map is based on the choices he or she actually makes.

As it stands, this pure version of the market could not possibly be of relevance to the law. Its underlying principle is the sovereignty and autonomy of every player in the market. The market is voluntary; its supreme principle is consent. But the law is coercive. The market depends on decentralized, uncoordinated decisions, but the law stands for centralized decision making. To achieve relevance to lawyers and policy makers, the system of Pareto efficiency had to undergo a transformation that would enable it to appeal to partisans of coercive intervention. How this transformation occurred is the tale we now tell.

Kaldor/Hicks and Collective Efficiency

The beginnings of the transformation took hold in the late 1930s, when a British economist, Nicholas Kaldor, turned his mind to a problem that national legislatures have often confronted.³ May they make a legislative

³ Nicholas Kaldor, "Welfare Propositions of Economics and Interpersonal Comparisons of Utility," 49 *Economica Journal* 549 (1939).

not gain something. The economist begins by noting that trade does in fact take place in the real world. His theory of Pareto-superior moves explains what we observe in the marketplace.

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change that will benefit the economy as a whole even if the change implies that a certain group in the society will lose? The specific problem was the nineteenth-century debate in Britain about the Corn Laws, the protective tariffs that shielded British farmers from foreign competition. A similar debate occurred recently in the United States about our joining the North American Free Trade Association (NAFTA). Participating in the tariff reduction program of NAFTA might be good for the country as a whole, but certain producers would lose out to cheaper Mexican imports.

Kaldor argued that abolishing the Corn Laws was a Pareto-superior move in the modified sense that the gains to the country as a whole from free trade were likely to be sufficiently great to outweigh the loss to some corn farmers. Kaldor believed that the winners could have purchased the right to remove the tariffs from the farmers and still have gains left over. That they could have purchased the right (but did not) meant that the move was Pareto-superior in a modified sense. Another economist, J. R. Hicks, quickly extended the argument to all market impediments.⁴

There is nothing surprising about the aim of these arguments. Free market economics imply general social benefits from free trade. Economists in this tradition are naturally opposed to tariffs and other impediments to competition. They understandably favored the repeal of the Corn Laws and other protective tariffs. An economist truly committed to free trade would think of the gains from tariffs as illegitimate, reaped by the grain farmers at the expense of the rest of society. Ending this illegitimate state of affairs is hardly a basis for thinking (even hypothetically) about compensation. There would be no more reason for Kaldor and Hicks to favor compensation for the farmers who would lose under the repeal of the Corn Laws than it would have been appropriate for abolitionists to pay compensation to the slaveholders who lost their human property under Abraham Lincoln's Emancipation Proclamation. Yet for some reason, it seemed important to Kaldor and Hicks to reconcile the abolition of a tariff with the principles of Pareto efficiency. This effort led them to inquire whether the society as a whole stood to gain enough from the increase in free trade to pay off (hypothetically) the farmers who benefited from the tariffs.

⁴ Cecil R. Hicks, "The Foundations of Welfare Economics," 49 *Economics Journal* 696 (1939).

It is sometimes said that hard cases make bad law, and this is an instance in which an easy economic problem (abolishing restraints on free trade) generated a dubious moral principle. Kaldor and Hicks's ruminations about the Corn Laws transformed the Pareto principle of efficiency into an instrument for legislation and judicial policy making. *The Kaldor/Hicks test*, as it is now formulated, holds that any reallocation of property rights is acceptable so long as it generates more gain to the winners than loss to the losers. This means that, in principle, the winners could compensate the losers and still have a gain left over. The emphasis here is on "could compensate"; they need not actually make the transfer for the change to be Pareto superior under the Kaldor/Hicks test.

To see how the Kaldor/Hicks test works in practice, let us return to our example of trading shoes for a television set. Suppose that the parties could not communicate with each other but that some third party (call it the state) knew that party A wanted a TV set and that she was willing to pay five pairs of shoes as compensation. The third party also knew that B was willing to accept five pairs of shoes for a TV set. This means that under the Kaldor/Hicks test, the state would be engaging in a Pareto-superior move by taking the TV set from B and giving it to A. A could compensate B for the set, and under ideal economic conditions, she would simply have bought the set from B. But in our imaginary situation, the parties are unable to trade, and therefore the state must do it for them.

Now you might wonder why the state should not at the same time take five pairs of shoes from A and give them to B. Perhaps it should. But the fact is that under the Kaldor/Hicks test, as interpreted by the school of L&E, A need not compensate B for the TV set. Herein lies the trick. In the original example of voluntary trading, the two transactions were conceptually linked—a TV set for shoes, and shoes for the TV set. The only basis we have for saying that the trade made the parties better off is that they actually made the trade. Yet under the Kaldor/Hicks test of hypothetical trading, the single transaction splits into two. Moving the TV set from one party to the other is one move toward efficiency in the Kaldor/Hicks sense, and moving the shoes in the opposite direction is another move toward efficiency.

Of course, you might be puzzled by all this. It seems very unfair to take the TV set from B and give it to A free of charge. If you confronted an advocate of the Kaldor/Hicks test with this problem, the conversation might go like this:

Skeptic: How can you do that? Take from one person and give to another? Do you think you're Robin Hood?

Advocate: I'm merely reallocating goods so that people who enjoy them more get to use them. You admit if A had to compensate B, she would go ahead and buy the set, and B would take the five pair of shoes for the TV set. Does not this show that A would enjoy that particular TV set more than B does?

Skeptic: Yes, it is clear that A and B would trade if they could. But without the actual trade, how do you know that A would actually pay five pairs of shoes for the set? Also, isn't it unfair for B not to get paid for the TV set?

Advocate: I'm stipulating that A would pay five pairs of shoes for the TV. After all, it's my example. As far as fairness goes, that is a problem of distribution, not of efficiency.

Skeptic: But in real life, you cannot stipulate how much A would be willing to pay. If you ask A how much she would pay (when she does not have to pay), she will, of course, exaggerate her willingness to pay. The only way you can know how much A would pay would be, as a good economist, to watch what she does, not what she says.

Advocate: How about looking at what some other person would pay for a TV set in a situation in which trading was possible?

Skeptic: You cannot do that. After all, the assumption of your "science" is that everyone has a distinct and different set of preferences. There are no other traders just like A and B.

Admittedly, this argument leaves out of consideration the possibility of measuring preferences across a large group of people by observing how they behave in the markets where there is choice between two versions of a single commodity. For example, if smokers were willing, on average, to pay 10 percent more to dine in restaurants where smoking is permitted, then we would have a rough idea how much particular smokers are willing to pay to light up after a meal.

Still, the point holds that the advocates of the Kaldor/Hicks test have manipulated the idea of Pareto superiority to make it suitable for the law. Kaldor originally advocated eliminating a restraint on free competition on the ground that it would benefit the society as a whole more than it would harm one segment of the society. The current advocates of Kaldor's

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revision of Pareto's principle now seek to reallocate property rights when it is more efficient to do so. There is method in this manipulation. The Kaldor/Hicks test converts a principle of voluntary market transactions into a standard for judicial intervention. Using the Kaldor/Hicks test, courts can redefine property rights "from time to time as the relative values of different uses of land change."⁵

As a result of the Kaldor/Hicks revision, the concept of efficiency takes on a new meaning. Efficiency is no longer synonymous with the workings of a perfect market. It becomes equivalent to a utilitarian standard justifying intervention in the market and in property rights when the benefits outweigh the burdens of intervention. Suppose, for example, that a railroad emits sparks and thereby destroys the property of a farmer with land abutting the railroad right of way. It appears that the railroad's sparks are encroaching upon the farmer's land and that therefore the farmer should be compensated for the resulting damage. But the Kaldor/Hicks test suggests a different answer. The relevant question becomes whether the railroad gains more from emitting sparks than the value of the loss to the farmer. As we will discuss later, the market could decide the question if the market is able to function properly between the parties. If the market does not work, then the Kaldor/Hicks test would require a court to assess which of the parties would make more valuable use of the land. That question turns out to be equivalent to determining which of the parties would pay more for the right to use the strip of (the farmer's) land potentially affected by the railroad's sparks.

As applied in cases of this sort, the Kaldor/Hicks test merely restates the utilitarian principle that, in a dispute about property rights, the courts should make the decision that would promote the interests of society as a whole. Awarding the disputed land to the railroad or the farmer serves the interests of society if the use of the land goes to the party who makes better use of it—with "better use" being measured by the economic rewards of railroading or farming. The only difference between the utilitarian and the advocate of the Kaldor/Hicks test is that the former relies upon the standard of happiness and the latter relies on a standard implicit in a hypothetical willingness to pay for the disputed resource.

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the Kaldor/Hicks variety because the culture of American law has long had strong ties to utilitarian thought. The devotee of L&E writes in a long line of theorists who think that all legal institutions should serve the interests of society—or at least of American society. Yet we have traced a remarkable transformation. The discussion begins with Pareto's principles of efficiency, grounded in the values of secure property rights, individual choice, and the necessity of voluntary transactions. In light of Kaldor's modest amendment, later generalized to cover all property rights, we end up with a theory of legal intervention that permits the periodic redefinition of property rights for the sake of a collective vision of efficiency. A theory of individual supremacy ends up as a philosophy of group supremacy. This is a remarkable metamorphosis. Any theory that can successfully obfuscate the difference between individual sovereignty in the market and the dominance of group interests in coercive decision making will surely gain a large number of followers.

Pigovian Efficiency

The preceding tale of transformation is not nearly as dramatic as another story that began to unfold at the University of Chicago in the early 1960s. Since the late nineteenth century, the courts have occasionally relied on free-market principles as a justification for liability in cases like that of the railroad sparks. These are cases of "externalities," typified by pollution and other burdens on society that the entrepreneur imposes on others. The basic claim has been that the law should serve to perfect the market by making each enterprise pay the full costs of production. Firms have to pay for the costs of capital and labor, but they do not have to pay for the social costs, such as sparks, air pollution, and noise, of the factories and machines they operate. According to the economic argument for liability, the free market cannot work properly unless these externalities are charged to the producers who generate them. Internalizing the social costs by forcing the entrepreneur to pay for them leads to an efficient allocation of resources. The injuring firm's liability costs are subsequently passed on to consumers in the form of higher prices. Consumers make the ultimate decision of allocative efficiency by purchasing those commodities that, in view of their costs of production and their harmful effects on others, best satisfy their preferences.

⁵ Richard Posner, *Economic Analysis of the Law* (3d ed) (Boston: Little, Brown, 1986) at 47.

To see how this works in practice, think about the way that the flying of supersonic airplanes used to inflict noise on the surrounding area as an externality. If the airline was not liable for the harm caused by its sonic booms, the price of a ticket would have been lower and consumers would have purchased "too much" supersonic travel. If the price of a ticket reflected the harm inflicted on people in the flight path (i.e., the externality is internalized), the price would have correctly reflected its social desirability. Consumer sovereignty would then have yielded the most efficient satisfaction of everyone's preferences—and the victims would have been no worse off, for they would have been compensated for suffering the noise. (The assumption, of course, is that some sum of money can make up for the disturbance of the ear-splitting noise.) Calabresi developed the same argument for the externality represented by automobile accidents.⁶ The harm that cars do to pedestrians and bicyclists is a social cost of producing and driving cars. By holding manufacturers (and drivers?) liable for accidents, the law could internalize the social costs of accidents in the price of cars. Consumers would then decide whether a vehicle as risky as the automobile is worth the cost. If manufacturers are not liable for accidents, the price of cars is lower, and consumers invest more in cars than in safer modes of transport. The policy of nonliability functions, in effect, as a subsidy to automobile manufacturers and distorts the free-market system as a mechanism for the efficient allocation of resources.

The distortion of the market results from subsidizing some producers at the expense of others. Any form of subsidy, whether it be for wages, machines, or the social consequences of production, has the effect of supporting weaker producers. The contrary principle is "Each industry must pay its own way." Lord Bramwell developed an argument of this sort in imposing liability against a railroad for emitting sparks and destroying an abutting farmer's crops. There was no doubt in his mind that the sparks were an externality of railroading, not of farming.⁷ There was no reason for the farmer to subsidize the railroad by bearing the loss himself. For those who believe in market efficiency, subsidies are an evil. The function of the law should be to eliminate the natural subsidy that occurs

when industries cause harmful side effects and they are not legally liable; the function of liability is to ensure that each industry pays its way.

This principle, now associated with the writing of English economist Arthur C. Pigou in the early twentieth century,⁸ has had a great impact on the law. It is the reigning view of externalities in the courts. It is an eminently sensible way of thinking about applying economic principles in legal analysis. The influential doctrine of "enterprise liability" also seems to be based on the idea that each enterprise in society should bear the cost in human suffering it inflicts on the unwary. Because of the Pigovian principle and its related doctrines in the law, we have witnessed an enormous expansion of products liability (i.e., when products cause injuries to consumers) over the last three or four decades. The expansion has been so great that many politicians now claim that American business is now less competitive with foreign producers who are not subject to the same demanding rules of products liability. Until the 1960s, this was the only theory in town. It seemed obvious that the way to internalize the social costs of industrial enterprises was to make them pay for the harm they caused.

Note the way in which the latter argument of efficiency differs from the Kaldor/Hicks standard of efficiency. The Pigovian claim is simply "Let the market work." Incorporate the social costs into the price, and let the consumers decide what they want and how much they are willing to pay for it. There is no need in this market-based method to make a centralized cost-benefit judgment, no call for a common denominator for expressing the value of competing interests. The process of internalizing the social costs of production need not assume what the economists call the "interpersonal comparison of utilities," a process implicit in reducing the competing interests to a common standard of measurement. The market works on the assumption of consumer sovereignty—each consumer is considered to be unique. Though we can rank her utilities and preferences, we cannot compare them quantitatively or qualitatively with the utilities (or preferences, pleasures, or pains) of anybody else. The great appeal of the Pigovian theory is that it demands fewer assumptions. All we need to assume is that consumers will make consistent decisions about what they want. Or so it seems.

⁶ See Guido Calabresi, "The Decision for Accidents: An Approach to Nonfault Allocation of Costs," 78 *Harv. L. Rev.* 713 (1965).

⁷ *Vaughan v. Taff Vale Railway*, 157 *English Reports* 1351 (Exch. Ch. 1860).

⁸ The first edition of *The Economics of Welfare* was published in 1920.

To see how this works in practice, think about the way that the flying of supersonic airplanes used to inflict noise on the surrounding area as an externality. If the airline was not liable for the harm caused by its sonic booms, the price of a ticket would have been lower and consumers would have purchased "too much" supersonic travel. If the price of a ticket reflected the harm inflicted on people in the flight path (i.e., the externality is internalized), the price would have correctly reflected its social desirability. Consumer sovereignty would then have yielded the most efficient satisfaction of everyone's preferences—and the victims would have been no worse off, for they would have been compensated for suffering the noise. (The assumption, of course, is that some sum of money can make up for the disturbance of the ear-splitting noise.) Calabresi developed the same argument for the externality represented by automobile accidents.⁶ The harm that cars do to pedestrians and bicyclists is a social cost of producing and driving cars. By holding manufacturers (and drivers?) liable for accidents, the law could internalize the social costs of accidents in the price of cars. Consumers would then decide whether a vehicle as risky as the automobile is worth the cost. If manufacturers are not liable for accidents, the price of cars is lower, and consumers invest more in cars than in safer modes of transport. The policy of nonliability functions, in effect, as a subsidy to automobile manufacturers and distorts the free-market system as a mechanism for the efficient allocation of resources.

The distortion of the market results from subsidizing some producers at the expense of others. Any form of subsidy, whether it be for wages, machines, or the social consequences of production, has the effect of supporting weaker producers. The contrary principle is "Each industry must pay its own way." Lord Bramwell developed an argument of this sort in imposing liability against a railroad for emitting sparks and destroying an abutting farmer's crops. There was no doubt in his mind that the sparks were an externality of railroading, not of farming.⁷ There was no reason for the farmer to subsidize the railroad by bearing the loss himself. For those who believe in market efficiency, subsidies are an evil. The function of the law should be to eliminate the natural subsidy that occurs

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The Coasian Reaction

Nothing makes academic waves more than a refutation of received wisdom. In the early 1960s, when the Pigovian theory was dogma in the analysis of tort liability, Ronald Coase, an economist then at the University of Virginia, burst on the scene with his article "The Problem of Social Cost."⁹ In 1963 Aaron Director, one of the early leaders in the nascent field of L&E, walked into class at the University of Chicago Law School and made a prescient announcement: This article will change the way lawyers think about law. He was right, at least about the way academic lawyers think about externalities.

Coase's basic claim is that what Pigou said "ain't necessarily so." Imposing liability against polluters and other injuring firms is not the only way to achieve efficiency in the allocation of resources. Coase has two basic strategies for countering Pigou. Both strategies depend on shifting the focus of economic analysis from decisions by consumers to potential decisions by victims. The first strategy is worked out in speculations about potential "bribes"¹⁰ by victims to prevent impending harm. Suppose that, unlike the example of supersonic air travel, there are no impediments to the victims bargaining with enterprises that injure them. To take Coase's example, a rancher must decide whether to let the *n*th (say, the third) steer graze on his property. If so, the steer will roam and cause harm to the neighboring farmer. Does economic efficiency require the rancher to pay for the harm? Pigou would say yes, in order to avoid the victims' (the farmer and his customers) "subsidizing"¹¹ the cost of beef by absorbing the damage done by the third steer. The gist of Coase's response is that the only relevant economic question is whether the rancher grazes the third steer or not, and that, he showed, was a function not of the liability rule but exclusively of the relative value of the steer to the rancher and the damage to the farmer's crops.

There are only four relevant cases. In cases I and II, the steer can generate \$300 in revenue for the rancher, and the crop damage is \$200. In cases III and IV, the figures are reversed: \$200 for the rancher and \$300 damage to the farmer.

⁹ 3 *Journal of Law and Economics* 1 (1960).

¹⁰ Economists often use terms like *bribe* in unusual ways.

¹¹ The comment in note 10 *supra* applies as well to the use of *subsidy* in economic jargon.

when industries cause harmful side effects and they are not legally liable; the function of liability is to ensure that each industry pays its way.

This principle, now associated with the writing of English economist Arthur C. Pigou in the early twentieth century,⁸ has had a great impact on the law. It is the reigning view of externalities in the courts. It is an eminently sensible way of thinking about applying economic principles in legal analysis. The influential doctrine of "enterprise liability" also seems to be based on the idea that each enterprise in society should bear the cost in human suffering it inflicts on the unwary. Because of the Pigovian principle and its related doctrines in the law, we have witnessed an enormous expansion of products liability (i.e., when products cause injuries to consumers) over the last three or four decades. The expansion has been so great that many politicians now claim that American business is now less competitive with foreign producers who are not subject to the same demanding rules of products liability. Until the 1960s, this was the only theory in town. It seemed obvious that the way to internalize the social costs of industrial enterprises was to make them pay for the harm they caused.

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⁸ The first edition of *The Economics of Welfare* was published in 1920.

Case I: *Premises*: \$300 gain for rancher; \$200 loss for farmer. According to the law, the rancher is liable for the damage by the steer.

Consequence: Rancher grazes the steer and pays farmer \$200 in damage costs. He retains \$100 of the gain.

Case II: *Premises*: \$300 gain for rancher; \$200 loss for farmer. According to the law, rancher is not liable for the damage.

Consequence: Rancher will obviously graze the steer because he nets the full \$300.

Case III: *Premises*: \$200 gain for rancher; \$300 loss for farmer. According to the law, rancher is liable for damage.

Consequence: Rancher will not graze the steer because his loss in liability costs to the farmer (\$300) would be greater than the potential gain (\$200) from the steer.

Case IV: *Premises*: \$200 gain for rancher; \$300 loss for farmer. According to the law, rancher is not liable for damage.

Consequence: Even though rancher is not liable for the damage, negotiations between rancher and farmer will result in the steer's not grazing. It will be worth it to farmer to offer rancher more than \$200 but less than \$300 (the loss that would occur from grazing) to induce rancher not to graze the steer, and it will be in rancher's interest to accept some sum greater than \$200 from farmer in place of the \$200 he could earn from grazing the steer.

This is all there is to the Coase theorem. In Cases I and II, the steer grazes; in Cases III and IV, it does not. This is a consequence not of liability but of the economic productivity of the rancher and the farmer. If it is worth it to the rancher and farmer to have the steer graze, it will graze; if not, it will not graze. It goes without saying that the same method applies to any conflict over whether a single resource, such as land or air, should be used in one way or another. You could play out the same argument in a dispute about smoking in restaurants or industrial pollution. The only assumptions necessary are that parties seek gain, that they are able to bargain with each other, and that they have full information about alternatives in the market. The only move in this demonstration that might puzzle the noneconomist is the resolution of case IV: Farmer will bribe rancher not to graze the steer if the numbers so dictate. The rancher will accept the bribe and hold back the steer. It seems unfair that a potential victim should have to pay "protection money" to someone who

might injure him. It is indeed unfair, but the premise of the economic argument is that fairness is irrelevant. It is efficient for the potential victim to pay not to be injured, and efficiency is the only value considered.

Though this brief demonstration is sufficient to prove Coase's theorem, his classic article is devoted largely to a second attack on Pigou. It seems very important to Coase to undermine the judgments that courts routinely make about who causes what. The point of this attack is clear. Pigovian analysis presupposes that we can determine which enterprises cause which injuries, that we can carry out the task that Calabresi dubbed "cost accounting." If there is no way to know whether the cause of sonic booms is flying supersonic planes or the failure of affected people to use thicker glass in their windows, then there is no way of applying the Pigovian principle to concrete cases. A little skepticism enables us to perceive victims as causal factors in their own suffering. After all, if the farmer insisted on planting next to the railroad, then of course the crops would be destroyed by spark-induced fires. If pedestrians walk near the highway, then they participate in bringing on accidents with cars. If it takes two to tango, then, according to Coase, it takes two to create pollution, an accident, or, indeed, any externality. The victim is as much of a cause as the industrial enterprise.

Though this causal nihilism is not a necessary part of the economic proof of Coase's theorem, it is a part of the general attack on the Pigovian tradition. The function of this attack, it seems, is to undermine confidence in making judgments about whether manufacturing automobiles causes accidents or, indeed, whether factories' emission of smoke causes air pollution. Despite the vigor of Coase's critique, however, the Pigovian principle has had far more influence in the development of the law than has the Coase theorem. First, the Pigovian principle applies in nonideal as well as ideal bargaining conditions between injurer and noninjurer. The Coase theorem does not apply in the case of supersonic travel because the costs of bargaining (organizing and communicating with the affected class) are insuperable. Coase has created an elegant theory limited to ideal conditions. He attempts to adjust his model to reality by noting that the costs of bargaining (transactions costs) will enter into the analysis of negotiating parties on whether to make a deal. For example, the farmer in Case IV will not bribe the rancher if the transactions costs are more than \$100, for in that case he cannot gain anything by paying the rancher his

minimum of \$200. (The fee to the rancher plus the transactions costs will be greater than the damage that the steer would do.)

The Pigovian theorem will continue to reign in the courts so long as the bench is staffed by lawyers rather than economists. In addition to its reader applicability, the Pigovian theorem dovetails well with the commonsense judgment that he who causes harm without justification ought to pay for it. "Making industry pay its way" appears to be a principle of fairness as well as efficiency. Coase will never succeed in the courts, because his view of efficiency is incompatible with elementary principles of fairness: It boggles the noneconomic mind to expect the farmer to pay the rancher to keep his steer from grazing.

The remarkable feature of Coase's theorem is that it has any influence at all. His theorem that the rule of liability does not matter under ideal conditions runs parallel to the model of voluntary bargaining under Pareto's principles. As the latter could not have impact without undergoing a transformation, so Coase's theorem could not guide legal thought unless it became a rationale for coercive legal intervention. A theory about the irrelevance of law might be exciting in the ideal world of economic models, but it is surely of little utility in the real world of legal conflict. The great mystery, therefore, is how the Coase theorem underwent a metamorphosis from a critique of Pigou's theory into a tool for analyzing liability in real cases of economic conflict.

Coase himself had virtually nothing to do with this transformation. The critical work came from those, like Richard Posner and the legions of L&E supporters, who saw in Coase an implicit endorsement of the market for solving legal problems. The steps in this reasoning can be broken down into these:

1. Under ideal conditions, the market will produce efficient results.
2. Efficiency is good.
3. Where the market does not operate perfectly (e.g., the problem of supersonic air travel), the courts should intervene.
4. What should the courts do? They should allocate liability in an effort to generate the result that a free market would generate if it could operate.
5. Why should courts do this? Because efficiency is good. (See step two.)

might injure him. It is indeed unfair, but the premise of the economic argument is that fairness is irrelevant. It is efficient for the potential victim to pay not to be injured, and efficiency is the only value considered.

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There we have it. A plausible defense for converting the Coase theorem into a standard for resolving concrete disputes: Mimic the market by assigning rights and liabilities. This particular manipulation of economic ideas should not come as a surprise. It replicates the intellectual history that led from Pareto's principles of bargaining under ideal conditions to coercive intervention under the Kaldor/Hicks test.

It is worth pinpointing the fallacy in the argument that courts should mimic the market. We must distinguish between two senses or conceptions of efficiency that have run through this chapter. One form of efficiency is built into a model of trading under ideal circumstances. If trading continues to the point that no further trade is possible without making someone worse off, then the resulting state of affairs is Pareto-optimal and, by definition, efficient. All that efficiency means in this context (as well as in step two) is that people get what they want. It is tautologically true that under ideal circumstances, the market will produce efficient results; it will give people what they want. This is an example of what Rawls calls "pure procedural justice."¹² If the game is played according to the rules, the outcome will, as a matter of logical necessity, be right.

A totally distinct form of efficiency derives from making cost-benefit judgments about whether the benefits to passengers of flying the SST outweigh its costs to people in the flight path. Flying a supersonic airplane is efficient in this sense if its benefits outweigh its costs. There is no market mechanism, no ideal game, for determining the balance of the competing goods and bads of supersonic flight. Ideal markets cannot be inefficient, but whoever makes a centralized judgment of efficiency in this situation might make a mistake and opt for an inefficient outcome. Ideal markets cannot be wrong, but centralized decisions can be, and they often are. In Rawls's terms, this is an instance not of pure but of imperfect procedural justice. I want to distinguish between these two conceptions of efficiency by calling the first *M-efficiency* (M for market) and the second *C-efficiency* (C for centralized). The first depends on the hidden hand of a decentralized market; the second, on the heavy hand of a single decision maker (or committee) that makes an assessment of competing costs and benefits.

If efficiency is good, it is good in these two different senses. *M-efficiency* is good because people get what they want; *C-efficiency* is

¹² John Rawls, *A Theory of Justice* 85-87 (Cambridge, MA: Belknap Press of Harvard University, 1971).

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good because it generates a net surplus of benefit over cost. The former is a libertarian value; the latter, good because it is better for society, collectively, to have more rather than less. The fallacy in the demonstration is the shift between these two meanings of efficiency. Step 2 is based on *M-efficiency*; step 4 on *C-efficiency*. The effort to mimic the market turns out to consist in centralized cost-benefit decisions. The pretense of mimicking the market, therefore, converts a libertarian value into a utilitarian standard for maximizing the welfare of the group.

Methods and Insights

The concept of efficiency suffers internal contradictions, but these contradictions may be no worse than those that infect the legal culture as a whole. Despite their obfuscation of the political and moral issues at stake, economists have brought great insights to the law and have stimulated debate about the foundations of liability. I group their contribution under the heading of "morality in the law," for their propositions are a form of moral argument. Either they argue in the libertarian tradition that individual autonomy and consent are supreme values, or they replicate, in a quite different language, the interventionist arguments of utilitarians.

The major difference between the economic and the philosophical style of argument lies less in substance and more in method. The philosophical style of this book expresses a primary commitment to clarity and conceptual analysis. Understanding differences and distinctions is a prime goal. In contrast, the methods of economists are functional rather than analytic. Their style of argument trades on perceiving similarities rather than differences. A typical economic argument is that a tax exemption is functionally equivalent to a grant-in-aid from the government. The similarity consists in the economic consequences of, say, a \$1,000 tax exemption and a \$1,000 grant-in-aid. The notion of "subsidy" is used rather freely in a similar way to describe any reduction of liability that runs counter to an assumed base line. Supporters of Pigovian theory would say that not requiring industry to pay for externalities is, in effect, to subsidize industry. Because they regard the assignment of externalities as a more fluid issue, supporters of the Coase theorem deny the charge of subsidization.

Calabresi is adept at spotting functional similarities. He claims that

both contract rights against specific people and rights to use things should be called property rights.¹³ Lawyers have spent centuries trying to clarify the distinction between rights *in personam* (against particular people) and rights *in rem* (against the entire world), but this distinction gets lost in a single stroke of the economist's pen. Calabresi also claims that the term *liability* should cover the case of a plaintiff who is denied recovery. We ordinarily say in this case that there is no liability, but Calabresi and many people influenced by him would say that the plaintiff is "liable" for his own injuries.¹⁴ The result of this careless speech is to camouflage the difference between getting stuck with a loss and being able to shift the loss to someone else.

Economic theorists of law are lumpers rather than splitters. They see similarities but downplay conceptual differences. They blur the meaning of causation, of property, and of liability. Other concepts fall as well to the impulse to see functional similarities. The distinction between corrective and distributive justice gets erased in the economist's division of the world into questions of efficiency and questions of distribution. The latter category includes both corrective and distributive justice.

The consequences of economic analysis of the law reminds us of the way legal realists systematically misused the language of discretion in order to make a valuable point about judicial creativity. The realists, too, were lumpers rather than splitters. They grouped together decisions by administrative agencies, decisions by police on the beat, verdicts by juries, and judicial decisions under the law. All of these turned out to be discretionary. Arguments of lumping generate a temporary sense of understanding: "Ah," says the student, "now I see a functional relationship I did not see before." The price of this understanding is a widespread debasing of the language. Without precise language, careful thought and argument come to an end.

Economic analysis of the law displays virtues as well as vices. The tension between these views and those who believe strongly that accident law should be about justice rather than efficiency has enormously enriched legal debate. Yet the most serious ramification of the L&E move-

ment has been the pretense that L&E is simply an extension of the neutral, nonpolitical science called "positive economics." In this chapter, we have attempted to show that though the argument begins in the methods of descriptive economics, it ends up by taking a stand on controversial moral and political principles of individual rights and group interests.

The supposed neutrality of L&E correlates in time with the emergence in the late 1970s of a large school of avowedly political scholars who campaigned under the banner of "Critical Legal Studies" (CLS).¹⁵ It's hard to know whether L&E itself triggered the CLS reaction, but the pretense of an apolitical science in law might well have had (and properly should have had) this effect. The central thrust of CLS is that political commitments play a greater role in the life of the law than ordinarily assumed. In recent years, the CLS movement itself has fragmented into diverse political camps, some arguing as feminists for women's interests, others stressing the significance of race and gender in thinking about legal issues.

The political reaction against the pseudoscience of economic analysis coincides with a renewed debate about the possibility of impartial thinking in morality and public affairs. The universal and impartial ambitions of Bentham and Kant have given way to a renewed appreciation for local and partial commitments. These, of course, are the commitments that drive political action. They support the aims of previously disempowered groups—such as gays and lesbians, ethnic minorities, and women—to assert themselves as "communities" with rights of their own. The new challenge for American law is to fathom the relationship between individuals and the groups from which they derive their identity.

Further Reading

A fuller exposition of these ideas is in George P. Fletcher, *Basic Concepts of Legal Thought* (New York: Oxford University Press, 1996). The works cited in the notes to this chapter are also of particular significance as the foundation of many of these concepts.

¹³ Guido Calabresi and A. Douglas Malamed, "Proper Rules, Liability Rules, and Inalienability: One View of the Cathedral," 85 *Harv. L. Rev.* 1089 (1972).

¹⁴ See Jules Coleman, *Risks and Wrongs* 230-232 (Cambridge: Cambridge University Press, 1992).

¹⁵ See generally, Roberto M. Unger, *Critical Studies Movement* (Cambridge, MA: Harvard University Press, 1980); Mark Kelman, *A Guide to Critical Legal Studies* (Cambridge, MA: Harvard University Press, 1987).