IS ECONOMICS ANY USE TO TAX LAWYERS? TOWARDS A MORE SUBSTANTIAL JURISPRUDENCE TO REPLACE LEGALISM

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INTRODUCTION

This article deals with some recent tax cases in 'black letter' areas of tax, more particularly some problem cases on deductions, to assess the usefulness of economic tools for legal analysis. Concentration on these deduction cases makes one acutely sensitive to the limitations of traditional legal techniques in frontier problem cases. When it is not just a question of manoeuvring facts within a settled framework of legal rules but one of deciding whether to extend the limits of past legal progress to a new problem, traditional rule-based techniques do not always promote rigorous analysis.

Judges may find it reassuring to rely on inductive reasoning based on an instinctive extrapolation from previous developments of doctrine or justify decisions breaking new ground by reference to vague terms like 'justice' whose connotation is never spelt out. I do not. Such devices, do not always paper over the inference that the legal 'science of muddling through' (as Lindblom terms techniques of pragmatic and incremental decision-making) sometimes promotes a groping in a 'horrid wilderness' of empty verbal games. The job of any responsive procedure for dispute resolution and for the channelling of human conduct must depend on an orderly and systematic set of criteria for evolution of the rule structure.

This article uses one or two very simple problems to spell out the difficulties with traditional legal techniques in the context of a simple tax provision dealing with the deduction of expenditures. Then it draws on a modified welfare economics model to analyse the same problems and to see if this improves analysis.

The argument does not make the usual generalized plea for inter-disciplinary work in law or mount a general attack on the limitations of Dixonian legalism. Nor does it make a full scale assessment of welfare economics. The objective is far more humble. It compares two models of problem solving *at the operational level* and, *compares them in the carefully demarcated area of problem cases.* The article concentrates on demonstrating

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that a modified welfare economics framework can act as a useful procedure, a legal algorithm, for systematic examination of the criteria for choice in problem cases in 'lawyers' ' tax law. I am not unmindful that both the rule model and the economic model have serious shortcomings. Nor am I unaware that if the economic model is adopted that this will have important institutional implications. Some of these problems will be touched on briefly.

TRADITIONAL METHODS OF JUDICIAL CHOICE

Decisions by appellate courts in problem cases involve choice. The issue is not *whether* these choices have economic and distributional consequences. They already do that. So much should hardly be controversial any longer. The only serious questions are first, whether the benefit of articulating those consequences and formally assimilating them into a framework of *judicial* decision-making outweighs the costs, and secondly, whether it is really practicable for courts to defer those choices to political institutions and, if so, at what price. No one can seriously assert that modern judges, privately, are not acutely aware of such factors when they go through the 'agony of choice'.

That said, some valuable space will still be invested in asserting the proposition that judicial decisions do make economic and distributional choices. In the course of a legal career it is easier to remember regrets about neglecting to reassert old but neglected truths than in squandering space on the obvious.

The vehicle for justifying the assertion is section 51 of the Income Tax Assessment Act 1936 (Cth), the key provision governing the deductibility of expenditures for tax purposes. The provision covers practical questions near to the heart of taxpayers such as the deduction of expenses for home studies, the deductibility of business lunches and travel, the expenses of getting to work. It also covers some significant social issues such as the deductibility of child-minding expenses by working mothers. But most importantly it has recently been the gateway through which some popular tax avoidance schemes have passed, including off-shore avoidance and service trusts and various schemes of the option purchase and pre-paid interest variety. In Australia the legislature was, until recently, content to articulate only a very general test for deductibility, leaving detailed norm creation to the courts. In contrast, in the United Kingdom, the legislature has covered most, though not all of these areas with detailed statutory provisions.

The language of section 51 is wider than its United Kingdom analogues. The key words are that expenditures are deductible 'to the extent to which they are incurred in gaining or producing' assessable income. There is an exception, among other things, for expenditure of a 'private or domestic nature'.

Lunney

Let us start with a typical if unspectacular authority on the application of section 51. *Lunney v. F.C.T.*[1] dealt with the claim for the deduction of the expenses in travelling from home to work. Were such travelling expenses incurred in producing assessable income? Possibly as a demonstration of class solidarity, the case consolidated the appeals of a wage earner and a professional, a dentist. The claims of both taxpayers were rejected by the High Court of Australia. Williams, Kitto and Taylor JJ. delivered a joint judgment. There can be no quarrel with the result. The Court drew on the familiar distinction between necessary and sufficient conditions. It rejected a test which rested deductibility on the basis that assessable income could not have been earned without the expenditure. Rather, the Court stressed the 'essential character' of the expenditure and its relevance to the scope of the operations. The Court drew on the United Kingdom authorities, citing *Newsom v. Robertson*[2] and summed up their reasoning in the following words:

> But to say that expenditure on fares is a prerequisite to the earning of a taxpayer's income is not to say that such expenditure is incurred in or in the course of gaining or producing his income. *Whether or not it should be so characterised depends upon considerations which are concerned more with the essential character of the expenditure* itself than with the fact that unless it is incurred an employee or a person pursuing a professional practice will not even begin to engage in these activities from which their respective incomes are derived.[3]

While the learned Judges obviously had a clear idea in their own minds of the concept of 'essential character' of an expenditure, such a label does not advance rational analysis of this problem, and this form of dissembling dangles a red herring for future problem cases. It is not clear whether they had a temporal-spatial nexus in mind, analogous to the much maligned concept of 'arising out of and/or in the course of employment' from workers compensation or some form of characterization based on some essential attribute of the advantage acquired with the expenditure. This sort of test does not help us when we deal with the case of an after-hours business dinner with an important client or the parking fees of a cripple who could not work without an expensive park below his central office (an actual case).

All of these expenditures can be linked 'causally' to the earning of assessable income. All of them can be linked in a quite plausible way to an increase in the personal utility of the taxpayer (the business dinner) or to the compensation for attributes peculiar to the taxpayer (the cripple's parking or child-minding fees). The problem becomes particularly acute in a case where the taxpayer engineers a scheme for tax purposes to siphon money to his family trusts to avoid tax. If we look at the facts, unhampered by a legal framework, it is manifest that:

[1] (1958) 100 C.L.R. 478.
[2] [1953] 1 Ch. 7, 16.
[3] (1958) 100 C.L.R. 478, 499.

1. The expenditure could in fact be shown to have been incurred to produce assessable income.
2. The expenditure could in fact be shown to have been incurred to increase personal utility.
3. That in all these problem cases it is possible to infer that the taxpayer's purpose was a combination of these.

To solve the problem, one can try to construct the dominant purpose of the taxpayer making the expenditure. This method has produced considerable problems in our idiosyncratic Australian provision on speculative profits, section 26(a) of the Income Tax Assessment Act 1936. In some cases it might be possible to extend the concept of apportionment to such cases; or one can work out some basis for choosing one or other option in an articulated framework of policy preferences.

But it is clear that a causal characterization within a rule model and unsupported by any other criteria hardly advances rational solutions to such problem cases. Causal tests project a comforting aura of scientific rigour. But it is an illusion in the context of problem cases. A causal chain has many links. The links one chooses to emphasize and to ignore turn on the initial theory with which one starts. When dealing with the artificial world of legal explanation we have no widely accepted criteria enabling us to choose between competing causal explanations. We are dealing here with artificial human constructs which simultaneously describe and have a significant effect in creating 'social reality'. In this legal universe of problem cases, if we are serious about developing principled procedures for rule creation, there is rather more utility in openly acknowledging the range of choices and in setting out to articulate those elements in our legal culture responsible for our causal preferences. We should examine those theories directly rather than second-hand as unarticulated premises in a causal analysis.

Lodge

Lunney was applied by the High Court of Australia in *Lodge v. F.C.T.*[4] to disallow expenditure for child-minding. The taxpayer spent $617 in nursery fees to have her daughter cared for while she prepared solicitor's bills of costs at home. Not surprisingly, she found she could not work satisfactorily with her infant daughter at home. Mason J. relied directly on *Lunney* and on the United Kingdom authorities to hold that deductibility did not turn on the mere fact that the expenditure was necessary for the earning of income. The decisive factor was the 'character of the expenditure'. He said that in the light of the earlier decisions he had *no alternative* but to arrive at the conclusion that the claim failed. He concluded:[5]

[4] (1972) 3 Australasian Tax Reports 254.
[5] Ibid. 256.

> The expenditure was incurred for the purpose of earning assessable income and it was an essential prerequisite of the derivation of that income. Nevertheless its character as nursery fees for the appellant's child was neither relevant nor incidental to the preparation of bills of cost. . . . The expenditure was not incurred in, or in the course of, preparing bills of cost.

For double measure he also held that the expenditure was of a 'private' or domestic nature.

This reasoning amounts to little more than an assertion that the expenditure was not causally related to the production of assessable income. It was conceded that income could not be produced unless the expenditure was made. The expenditure, temporally speaking, did take place during the course of earning income. It can hardly be material where the child was minded. The critical question about the basis for choosing the particular causal characterization is not mentioned.

The problem is whether, as a matter of fact, expenditure was incurred to produce income. Now clearly, as a matter of fact, the expenditure did have purposes other than the production of income. But this alone can hardly be a basis for excluding it because many allowable expenditures have other purposes: the business account lunch or the pleasure from an overseas trip by a buyer or the personal prestige gained by a managing director from his own fine office. How then is it characterized? Child-minding fees are not self-evidently personal. If the mother had personally looked after the child she would not have incurred such expenses. In that sense they are work expenses. It seems an extremely well-balanced case. The judicial formula does not satisfy me and one is not at all sure that if the inarticulate interpretative model of the learned Judge was laid bare that it would withstand critical scrutiny. When we are asking whether child-minding fees are deductible we are told that they were not incurred in preparing bills. When we are asked whether expenditures for services are deductible in cases where a service trust was set up with the dominating objective of siphoning money out of a partnership of accountants, we are told it was to pay for essential services to the trust.[6] The formula provides no principled justification for the critical characterization and raises some suspicion of a preference for one group of taxpayers, and that preference is certainly not for the poor working mother.

AN ECONOMIC FRAMEWORK

The model applied as an alternative framework for analyzing these problems is elegantly expounded by Calabressi and Melamed, 'Property Rules, Liability Rules and Inalienability: One View of the Cathedral'.[7] It extends and drastically modifies the welfare economics model. There is little utility in traversing again that crisp argument or in trying to summarize

[6] Schemes popular in Australia as a result of the decision in *F.C.T.* v. *Phillips* (1978) 78 A.T.C. 4361.

[7] (1972) 85 *Harvard Law Review* 1089; see also Mishan E. J., 'Pareto Optimality and the Law' (1967) 19 *Oxford Economic Papers* 255.

a growing body of economic literature in America, particularly in the tort and landlord and tenant areas.[8] The objective of this article is to demonstrate the viability of the model, not to get it into full operational order. Instead a framework will be extracted as a basis for critically analyzing our particular problems. But one important point ought to be stressed. Economics, though among the most analytically developed of social theories, does not contain a core of easily applied uncontroversial doctrine which can give precise solutions to problem cases. Lawyers are practical problem solvers who have not the luxury of reaching consensus after long discussion of each problem. The theory developed here is less an economic model than an idealized and simplified *procedure* for practical problem solving drawing on the economic tradition. It is analogous to the algorithm a computer programmer uses to reduce a problem into a form suitable for machine coding. The model is as follows:

1. Whenever a state is presented with the competing demands of two or more people it must decide which side to favour. Calabressi calls this the creation of entitlements.
2. In deciding on such entitlements there are three heads under which decisions can be made —
   (a) economic or, more precisely, allocative efficiency
   (b) distributional preferences
   (c) 'other justice' considerations
3. The concept used for assessing the allocative efficiency of a particular policy borrows aspects of a welfare economics concept known as Pareto optimality. Under this concept *a decision-maker would choose one set of entitlements in preference to another only if that allocation of resources would improve the condition of those who gained by it sufficiently to compensate those who lost by it.* Used in our model it measures allocative efficiency, for any *given* distribution and quantity of resources. The dominating premise of the theory and its main measuring stick is the individual's perception of his own utility.
4. Distributional preferences are difficult to integrate into a single conceptual framework. There is first the major concept of equality or fairness and the prolonged debate about Rawl's theory of justice. But this competes with preferences linked to more particular values. For example, there is the *value* that the persons who produce wealth ought to be entitled to a greater share of its fruits. There are value judgments that silence lovers ought to be preferred to noise polluters, that tax-

[8] Other recent examples of the application of economic models are Markovits R. S., 'The Distributive Impact, Allocative Efficiency and Overall Desirability of Ideal Housing Codes: Some Theoretical Clarifications' (1976) 89 *Harvard Law Review* 1815 and the tort examples cited in Calabressi and the vast literature cited in Polinsky A. M., 'Economic Analysis as a Potentially Defective Product: A Buyer's Guide to Posner's Economic Analysis of Law' (1974) 87 *Harvard Law Review* 1655, 1656 (n. 4).

payers with dependant children should be treated more generously than single taxpayers, that tort compensation schemes ought to protect the expectations of those with high incomes at the cost of benefits to those with low incomes. There is also the over-riding value that, irrespective of general distributional preferences, society's conscience is shocked unless people have minimum provision of particular commodities like food or shelter or education. This idea has been termed 'specific egalitarianism'.

5. 'Other Justice Reasons' is a ragbag category. It might include, for example, the pressure on a decision-maker to be *seen* to act consistently. It is too vague to have any analytical utility. In my opinion it is best to see this category as proscribing the limits of the modified welfare economics model. The model is an idealized framework to guide principled action. It can hardly remove a specific decision from the specifics of political and administrative pressures in a particular society. If we are serious about using these models it is best to constantly reiterate the limits of generalized rationalist models. They are heuristic devices enabling us to see problems in sharper relief and frameworks for informed value choices. They are *not* complete problem solving structures.

APPLICATION OF THE ECONOMIC MODEL

We can now apply the modified welfare economics model to the trite fact situation in *Lunney* to see if it helps to decide whether fares to work ought to be deductible. Applying allocative criteria, the community is asked to forego tax to 'subsidize' the costs of getting to work. This will make it cheaper for those living a long way from work to get there. In the longer term, it will make land some distance from working locations relatively more attractive. If the utility of individual home owners is accurately aggregated by supply and demand criteria in the price of housing, this will distort such pricing. It will cause land to be allocated sub-optimally, it will channel more resources into building houses in suburbs far from jobs and give windfall gains to outer-suburban house-owners. There is no obvious pay-off in increased wealth which would allow those who gain to compensate for the extra tax we can assume would be borne by other taxpayers or persons who benefit from taxation. It thus fails on the primary Pareto criterion. Secondary effects like the subsidy to transport and car manufacturing, the increased demand for petrol, increases in decentralization and urban sprawl could also be fed progressively into the model but can be ignored for present purposes.

The distributional question is ambiguous but instructive. We create an entitlement for travelling taxpayers. In the longer term, the burden is borne by those taxpayers who travel less than average and, whether directly or indirectly through increased deficits and inflation, by those who depend on

government largesse. To oversimplify, this will benefit travelling taxpayers at the cost of a mix of other taxpayers, welfare beneficiaries and savers. This is a clumsy way of lowering tax rates, so we can ignore all the arguments for lowering tax rates based on incentives and higher productivity. It is unlikely that satisfactory empirical evidence would be available to assess the distributional effects of subsidizing travelling taxpayers. But even an over-simplified 'guesstimate' with full awareness of information constraints is better than using criteria which obscure such questions altogether. For the purpose of illustration let use take a grossly simplified set of postulates (rapidly getting out of date):

1. That all work places are in the centre of the city, say Melbourne.
2. That the nearest ring of suburbs are populated by the poor.
3. That the next belt of suburbs are populated by the upper middle-class and wealthy.
4. That the vast majority of the middle-class inhabit the outer ring of new suburbs.

Given such simplified assumptions, the distributional effect of the travelling subsidy would be dramatic. The poor, including welfare beneficiaries and the old with savings, would be relatively worse off. This would primarily subsidize the middle class. This in effect would increase capitalization of existing house values reflecting future discounted subsidies. This would give the middle class suburbanite a capital windfall. There would be a redistribution primarily from the poor up the income scale. Under our model, the rich would benefit slightly because the deduction would be worth more to higher marginal rate taxpayers, but if they tend to live far from work on weekend farms or stock-broker belts the subsidy would be from the poor to the rich. The irony is, of course, that the very implication which would make this anathema to Pareto or Rawls might make it attractive to practical politicians and, possibly, even judges seeking the illusive consensus. But our conclusion is fairly clear. There are no compelling welfare economics or distributional priorities which would justify the heavy administrative costs of creating an entitlement to deduct travel expenses. Ironically, with a movement of the poor to outer suburbs and the wealthy to the city the whole analysis could be turned on its head.

The deductibility of child-minding expenses, in *Lodge*, is anything but a trite application of the model. On allocative criteria, it would be a good guess, or at least a hypothesis for testing, that such a visible 'subsidy' would encourage more mothers into the work-force. Whether this would lead to an increase in output would turn on present levels of unemployment and whether mothers are likely to supply skills in short supply. Obviously, expert evidence would be required to decide these questions. For present purposes, we can hazard a guess that a larger pool of workers will increase total production, but whether this would be great enough to pay the total cost of the scheme would be more problematic.

But, of course, the entry of women with higher job qualifications on the labour market would, in the short term at least, take some jobs from less qualified workers, male and female, some of whom will be the sole bread-winners for families. To assess the total distributional impact, we would also need to assess the income strata most likely to be attracted by such a subsidy. But, in Australia at least, it is striking how prominent single parent families are among the bottom two deciles of the distributional totem, the poor and very poor. Careful weighing of the costs against benefits might very well indicate that this was a cost-effective means of helping the poorest parts of the community to help themselves. It would also promote the important, specific egalitarian value that children of disadvantaged parents should, so far as practicable, be adequately supervised and should not suffer for the mistakes or misfortunes of their parents.

Neither the economic or distributional issues are likely to give unambiguous indicators but the framework certainly structures the issues in an intelligent way.

INSTITUTIONAL IMPLICATIONS: THE RULE MODEL IN PROBLEM CASES

Now let us go back and spell out the obvious inferences from what *the Court* did in *Lodge*. The statute certainly did not answer the question whether child-minding fees were deductible. The effective choice, within very wide limits, was delegated to the Court. The Court exercised the discretion to create a significant norm without any serious attempt to justify the critical policy choice. Far from articulating any rational justification for its exercise of discretion, the Court engaged in a process of manipulating a verbal formula which communicated little falsifiable information.[9] The effective decision was simply pushed one step further back into the nebulous region of collective judicial consciousness and its unique variant in the mind of this particular Judge.

Now it is obviously possible to ask whether such techniques can be justified in a particular case as a foil to an over-zealous executive or to powerful private interests or even as a means for making necessary concessions to powerful private interests in order to preserve political cohesion. There are obvious payoffs for judges, so long as they can get away with it, in fudging politically sensitive choices and drawing legitimacy for a norm from the assertion, or even the internalized belief, that an exercise of discretion flows directly from parliamentary words. But even assuming merit in such an argument, and, it ought to be treated with scepticism, the successful use of such techniques exacts important costs to other values.

[9] Karl Popper argues that the information carried by any statement is measured by the possibility of proving it wrong according to criteria accepted by both parties to a discourse. Thus, the statement that 'Monash University is in Melbourne' contains more information than 'Students at Monash are good people'.

Not only do such techniques insulate an important part of the polity from effective democratic answerability but the correlative verbal rationalizations can create confusion among those in the business of advising clients and it can inhibit the ability of judges themselves to monitor decisions and intelligently weigh values. If we are to take the rhetoric seriously that the rule of law really is government by clear and impersonal rules rather than *ad hoc* decisions by officials we should take care to avoid manifest contradictions of the principle by carefully circumscribing its limits.

INSTITUTIONAL IMPLICATIONS OF THE ECONOMIC MODEL

Even assuming the limitations of the traditional rule model in problem cases, is not the obvious point about the economic model that lawyers are just not qualified to engage in such analysis? The retort is even more obvious. The Court in *Lodge* did make an economic-distributional decision. The decision had all of the effects described in the model, whether the Court chose to articulate them or not. In any event, to protest disqualification on the ground of skills is only a partial reply. To argue that probing in a verbal vacuum at the fringes of the rule model is preferable to orderly analysis according to articulated standards is not to rebut a diagnosis of the deficiencies in the legal methodology or the utility of the model developed in this article. It might be an argument for tooling up much more seriously for such work in legal education or for redirecting legal research. It might also be an argument for detailed executive monitoring of court decisions before they become imbedded in social and business practices. This would lead to the gradual shifting of traditional judicial procedure though not necessarily lawyers to the periphery of social control in post-industrial bureaucratic society (and there are signs this is happening in some areas).

It is not difficult to find a range of objections to this change in judicial roles and the law jobs. They take two divergent directions. On the one hand, it is argued that articulation of economic and distributional criteria would undermine legitimacy. Traditionally, judges have maintained legitimacy and legal profession cohesion by creating norms in a closed system based on the rule model, even if it was often frayed at the edges. Is it necessary to maintain verbal devices despite their weighty dysfunctions in problem cases to protect that legitimacy? My own view is that increasing public awareness is rapidly eroding this basis of legitimacy and we further expose it by using it in contexts where policy choices are manifest. Better in problem cases to rely on wider bases for legitimacy such as well-accepted theories from relevant disciplines rather than protecting the purity of our closed rule model to the death.

On the other hand, it has been argued that reference to such wide criteria would make judges *too* powerful. If they habitually articulate wider justificatory criteria in problem cases, judges may get the courage and

power base to challenge parliamentary or executive norms in a wide range of situations. Would this threaten the division of power? This raises the question whether a vigorous common law has any place in the emerging corporate state or whether it ought to be allowed to wither as an appendage to outdated liberal institutions. Without attempting to answer this massive question, I should say that it is necessary to resist the temptation to *assume* that reposing such questions in executive policy units will necessarily improve decisions. The reasoning would go that lines of authority in democratic processes can be so stretched in the case of complex problems in large bureaucracies that interest group participation in judicial norm creation may provide a better, albeit inadequate, approximation for participatory democracy. Much of American administrative law is based on this premise. There is also the reasoning that social science theory is so underdeveloped and the problems of general theory so great that step by step norm creation, with its built-in advantage of immediate feed-back from concrete problems and publicly articulated justifications, may well be coming back into its own as a problem-solving mechanism. It is not beyond the imagination of man to see even our ponderous legal system adapt its identity and abandon the tattered myth that courts do not exercise discretion to carry out a constructive role in the corporate state.

THE LIMITS OF THE ECONOMIC MODEL

I hold no brief for the economic model. As a tax lawyer, one is easily persuaded by the obvious inadequacies of a rule-based model in problem cases and the need for techniques to systematically structure problems for intelligent analysis. The economic model, if only as an interim step, is the obvious choice because it is so well developed in the literature and so well understood by policy makers. But we need to be conscious of the important implications of choosing any particular model, be it this model or any other.

We can start off by examining the limited assumptions of the modified welfare economics model and the methodological implications. This can lead us to a perspective where the model can be viewed as a form of ideology and where suggestions can be made for restructuring it to do better the legal jobs demanded of it. It must be stressed that this is merely a brief run through some troubled country, a lawyer's 'World Tour' which raises as many questions as it answers. Much more research is necessary.

The modified welfare economics model is solidly rooted in neo-classical economic theory and subject to the well rehearsed limitations of this rationalist theory. It assumes that individuals pursuing their own self-interest will optimise their own utility. It assumes that there is a free market and that that market, to put it in the economic jargon,[10] operates without 'trans-

[10] Galbraith J. K., *The New Industrial State* (1967) as subsequently modified in Galbraith J. K., *Economics and the Public Purpose* (1973) and see Tribe L. H., 'Technology Assessment and the Fourth Discontinuity: The Limits of Instrumental Rationality' (1973) 46 *Southern California Law Review* 617, 625.

ation costs'.[11] The simplified assumptions exclude impediments to free exchange such as monopoly, assume perfect knowledge by individuals in the market, assume no costs in negotiating and so on.

We can deal with the well-known frontal attack on the economic model popularized by Galbraith and Stuart Holland. The broad thrust of these criticisms[12] is that the simplified assumptions when applied to the key areas of economic activity in advanced capitalist societies are such a distortion of reality as to obscure rather than clarify the real dynamics of that system. Firms in key areas do not respond to consumer preferences, Galbraith argues; they systematically, if imperfectly, control consumer preferences through advertising and dominant market positions and they have considerable influence over a range of complimentary government decisions. Polinsky echoes these criticisms in the context of a critique of Posner's neo-classical *Economic Analysis of Law*:[13]

> The competitive market paradigm which is the basis of Posner's approach, requires a number of stringent assumptions, many of which are likely to fail in the context of the real world problems which Posner analyzes . . . the crucial assumptions are more likely to fail in those areas in which the law plays an important role.[14]

The offending list of assumptions parallel Galbraith's and similarly summarize the imperfections of the market in the real world. In particular, costs of litigation can be seen as important 'transaction costs'.

Unger, in his recent *Law in Modern Society*,[15] uses the neo-classical model as a vehicle for a broad-based attack on rationalist method. The book is full of rich insights, but taken out of context, this part of the analysis can be misleading. He says:

> The rationalist strategy [exemplified by neo-classical economics] starts with the selection of a few general premises about human nature, chosen for the explanatory power of the conclusions they make possible rather than for their descriptive accuracy. From these postulates it draws a growing string of consequences by a continuous process of conceptual refinement. . . . The whole body of thought . . . disclaims any pretence to describe what actually happens in social life.

Unger is, of course, only setting up a straw man so that he can later argue for reintegration of positivist social theory and normative examination of objectives. My assertion is that, far from disclaiming any pretence to describe what happens in social life, the strength of economic theory as an explanatory device turns precisely on its ability to persuade sufficient politically significant human beings that it did or does describe 'reality'. Its strength lies in the very closed nature of the system developed. This is not to say that such explanation will satisfy social scientists with other explanatory

[11] Holland, S., *The Socialist Challenge* (1975).

[12] Coase R. H., 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1 and see subsequent discussion in Calabressi G., 'Transaction Costs, Resource Allocation and Liability Rules — A Comment' (1968) 11 *Journal of Law and Economics 67* and Nutter G. W., 'The Coase Theorem on Social Cost: A Footnote' (1968) 11 *Journal of Law and Economics* 503.

[13] Posner R. A., *Economic Analysis of Law* (1973).

[14] Polinsky, *op. cit.* 1680.

[15] Unger R. M., *Law in Modern Society*: toward a criticism of social theory (1976) 11.

systems to draw on or that human beings are objective in assessing models or that the theory might have become so entrenched by the organization of physical relations in the economy that it is sustained long after the dissonance between the theoretical universe and 'objective reality' becomes manifest. The important insight is that models are more than explanatory tools, they are also modes of selecting and organizing reality, they are tinted windows through which a culture sees the world. Social scientists may develop certain criteria of objectivity for the enterprise of describing the world but their enterprise, precisely because it so critically constrains the view a society has of social 'reality' and the agenda of social problems, particularly in complex areas like tax, can never be objective in the sense of being non-political. Current generalizations about 'reality', the models which organize that reality and the consequences of the models must constantly inform each other in the adaptive process of building models to intelligently direct social evolution.

THE ECONOMIC MODEL AS 'IDEOLOGY'

Pareto optimality comes into play *given* any initial set of entitlements. The theory postulates that resources ought to be reallocated so long as the gains from reallocation are sufficient to compensate losses. *It does not follow and often will not be the case* in the current state of the theory, *that the losers will actually be compensated by the gainers.* Thus the distributional consequences of a particular policy are excluded from the formal Pareto framework. A tax policy which increases investment and output would go ahead on Pareto criteria alone even in a wealthy society where it is financed wholly by persons below the poverty line and the benefits, let us assume, are retained wholly by the wealthy. So while the Pareto model itself is formally distributionally indifferent it has this important normative bias imbedded in its structure. The Calabressi modification does not wholly compensate for this. By excluding distributional questions from the agenda of the central allocative discussion it can act to build in a preference for easy to measure and 'empirically rigorous' economic priorities over hard to measure and conceptualize and therefore 'political' distributional priorities.

The allocative value choice is clothed in the value-free language of economic positivism while the distributional question is presented as soft and value-loaded. The framework has all of the subtlety of a successful ideology. Among others, Habermas in his *Legitimation Crisis* has poured scorn on the much heralded 'end of ideology' in the Western democracies. The new ideology, he argues, is embedded in a framework of technical rationality which, behind a bland facade of formal neutrality, contains an assymetry committing societies to existing priorities and the protection of existing distributions of power and wealth.

On the other hand, and on a less grand level, the model does give a decision-maker a systematic means of analysing the allocative costs of

various distributional preferences. It helps us to ask who benefits or is harmed by a particular decision. This information can itself inform and influence our values. It is preferable to power exercised behind a facade of ambiguous words. While it is clearly necessary to better integrate distributive and other priorities into the model, it is a step towards recognition that conflict in problem cases ought to be adjusted by reference to an over-riding framework of articulated and principled criteria.

MODIFYING THE ECONOMIC MODEL FOR LEGAL USE

A third line of criticism of the economic model and a means of future refinement is developed by Fred Hirsch in his *Social Limits to Growth.*[16] The critique is at three levels.

First, Hirsch attacks the assumptions in neo-classical models which collapse[17] 'individual and total utility into a single process grounded on individual valuations'. In particular, he shows that the utility that individuals derive from goods and services after the satisfaction of basic material needs depend increasingly on the consumption of others (for example crowding on roads, limited access to scarce jobs and land). In these situations, typical of advanced Western societies, an individual decision in pursuit of perceived self-interest will not optimise the utility of that individual. What is rational for a single individual may well be irrational if everyone else is doing it.

Secondly, Hirsch argues that neo-classical models have been too successful. They have spilled over into the political arena, and now, we propose, into the legal arena also. The underlying philosophy of individual maximization has inflated expectations and, correlatively, political demands beyond the steady but limited capacity of Western economies to deliver.

Thirdly, and most dramatically, Hirsch has shown that the philosophy of individual utility maximization can operate effectively only in tandem with a supporting social ethos. Even the most extreme free market models, he argues, require a framework of political stability and principled rules to support free exchange. But, and here is the rub, the philosophy of individual utility maximization has been instrumental in undermining the public policies increasingly necessary to supplement the market as a society becomes increasingly specialized and interdependent. Hirsch says that appeal to private self-interest:

> remains in many situations the most effective instrument for attainment of the immediate objective. But by weakening the norms of deliberate co-operation and social restraint, reliance on this appeal as the dominant value of society produces an unstable system over time.[18]

This line of argument is echoed by Unger[19] when he says that liberalism is a form of social life which most depends on impersonal rules yet is the

[16] Hirsch F., *Social Limits to Growth* (1977).
[17] *Ibid.* 10.
[18] *Ibid.* 157-8.
[19] Unger, *op. cit.* 264.

form of society least able to shape and apply them. What do you sensibly say to restrain carburetor workers holding a whole motor industry to ransom or to an *élite* of tax avoiders with political clout when they know that everybody else is pursuing their own narrowly defined self-interest? Is all talk of 'community' mere cant? It takes an anthropologist to drive home the full implications of this insight, to see neo-classical individual maximization as a form of consciousness supported by social organization and, despite its manifest inadequacies, by politically significant human beings, who dare not let go of the tattered conceptual bone.

For our purposes, the vital inference is that a functional legal model must not lose sight of the judicial job of channelling behaviour. The economics model provides a technique for systematically setting out the values at stake in legal problem cases. It does not purport to construct a comprehensive framework for principled legal decisions. Lawyers are certainly in the business of resolving immediate conflict. But they are also in the business of building an idealized structure to mould the collective culture of human beings irrevocably committed to social existence. Such a framework would seek to optimize individual autonomy by removing from individual human beings the burden of having to pursue their self-interest beyond the limits where reciprocity can be sustained. For such a framework we need to search more widely.

CONCLUSION

This article set itself the narrow objective of demonstrating the practicality of going beyond old-fashioned closed rule models with a simple well-understood economic model. That such an adventure opens Pandora's box to a new set of problems is not denied. But the thrust of the argument is that in the frontier problem areas lawyers are faced with a choice of evils. The old closed rule model is so tattered that it threatens to undermine the credibility of legal dispute mechanisms.

It must be stressed that the argument is not some isolated frolic based on dissatisfaction with a couple of tax cases. It builds on earlier arguments demonstrating the extreme inadequacies of legalism and of problem solving by playing the category manipulation game in a vacuum.[20] The argument is an application of a historical analysis of law recently developed by Nonet and Selznick, *Law and Society in Transition.*[21] These writers construct a framework to explain the development of law in three stages, which we can adopt and develop for our purposes.

1. Repressive Law. The law is merely an instrument for social control used by a ruler or ruling *élite.* Order is the main pre-occupation of law.

[20] Grbich Y., 'The Duke of Westminster's Graven Idol: On Extending Property Authorities in Tax and Back Again' (1978) 9 *Federal Law Review* 185, Wallace J. and Grbich Y., 'A Judge's Guide to Legal Change in Property: Mere Equities Critically Examined' (1979) 3 *The University of New South Wales Law Journal* 175.
[21] Nonet and Selznick, *Law and Society in Transition* (1978).

2. Autonomous Law. The law develops a degree of detachment from the ruling *élite* and an autonomous power in society based on its widely perceived commitment to objectivity and internal rigour.
3. Responsive Law. The law breaks out of a closed system of internal justifications for its actions and lawyers see themselves as committed to substantive justice. They evaluate decisions by reference to the effects of those decisions in the real world. The manipulation of words in a closed system gives way to decisions justified by reference to articulated social and economic standards. The powerful insights of open systems theory permeate the legal culture.

If we see legalism and a closed rule system as the 'operational ideology' of autonomous law, we can see the undermining and public dissatisfaction with narrow legal justifications for judicial decisions as a widespread rejection of autonomous law as sufficient basis for legitimacy in an advanced society. We can also see it at the same time as a demand for responsive law. The self-interest of lawyers requires that they respond to these demands in order to maintain the legitimacy of the system they operate. It is not important whether the model developed in this article finds wide appeal. The important point is that autonomous law and its attendant legalistic tools can no longer do the job and, more importantly, is manifestly seen not to do the job. A systematic framework for responsive law is overdue. The onus on any academic attacking the approach developed in this article is not to show the model is inadequate. Clearly it is inadequate. The job is to develop a model which works better on the operational level. Some hard work lies ahead.