UTILITARIANISM, ECONOMICS AND THE COMMON LAW

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There is an ambitious claim made by some of the proponents of the new "law-and-economics" field that the disciplines of law and economics are much more integrally related than if economics were merely of assistance to a lawyer involved either in the creation or application of legislation, or in the interpretation of those areas of law where there is a clear economic rationale, such as monopolies and restrictive practices legislation.

The idea is most clearly expressed in Richard Posner's writings.[1] His claim, which is shared by many of his disciples, particularly in the United States, is that an economic interpretation of judicial decisions can yield criteria both for the criticism of existing decisions and for the justification of future decision-making. This way of analysing legal decisions is to be distinguished from the ways in which economics can be of assistance to the lawyer in interpreting legislation for the economic analysis of law, in Posner's sense, centres upon the common law and purports to discover an economic rationale behind all common law decisions. The thesis is, briefly and crudely, that the correct judicial decision is the one that is the most cost-efficient.

Posner's claim that an underlying economic rationale can be discovered for all common law decisions has been accepted if not always explicitly acknowledged by a surprising number of writers in both the United States and the United Kingdom.[2] On the other hand it could be noted that several writers now regard his claim as too wide, preferring to concentrate on areas of the common law which more apparently suggest economic transactions, most usually tort and contract.

If Posner's claim is wrong then the justification for analysing legal decisions in this way stands in need of further justification. And if the assumption or theory upon which his kind of economic analysis of law is based is unsound it is reasonable to suppose that it is unsound for all areas of law: the fact that some areas of the common law could possibly have some economic elements will not be a sufficient argument in favour of his economic analysis applying, say, to tort and contract. To repeat: if the assumptions behind economics and law-making (including adjudicating) are different, economics cannot yield conclusions about judicial decision-making that are of much significance to lawyers and judges.

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1 Especially *Economic Analysis of Law* (2nd ed 1977) and *The Economics of Justice* (1981). Also, "The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication" (1980) 8 Hofstra Law Review 487.

2 See, for example, Bishop, "Economic Loss in Tort" (1982) 2 Oxford Journal of Legal Studies 1.

Certainly there are two major assumptions that Posnerite economists make in interpreting judicial decisions. In the first place, they assume that judges should maximise wealth in controversial cases. This proposition involves three further refinements. (i) Maximisation of wealth means maximising the overall number of choices in society as measured by the model of the rational self-maximiser. (ii) The rational self-maximiser, because he is maximising his choices, will be better off in the sense that he gains the possibility of increased want satisfaction. (iii) The problem of the interpersonal measurement of choices or utility is solved by the use of a money as a measure of possible want satisfaction. In the second place, Posnerites assume that the economic analysis of judicial decisions is valuable even if judges and lawyers do not speak as though their decisions were based on economic criteria.

The first assumption must be one to which lawyers appeal, if only instinctively, if economic analysis is to be of relevance to the justification of legal decisions in controversial cases. The first proposition and its refinements amount to a crude version of utilitarianism and indeed many economists would claim precisely that to be the underlying assumption of their discipline. But it should follow that this same crude version of utilitarianism should underlie the common law system; it does not appear to in at least two important aspects. First, it does not clearly follow that because the utilitarian consideration of wealth maximisation is a guiding principle in ordering our legal system, judges should make decisions that maximise wealth in individual controversial cases. In utilitarian terms, it may be argued that consideration about following the rules (or deciding consistently with the rationale underlying previous decisions) will lead in the long run to greater wealth maximisation, although in the individual case it might not. Here a version of rule utilitarianism achieves some consistency with the economic analysis: if the courts pay attention to applying the precedents and so on, irrespective of economic impact, the combined effect in the long term will be maximisation of wealth. But this sort of claim is very difficult to test and is far from having been established.

But the other more serious objection is that it is perhaps not the case that such a crude wealth-maximising utilitarianism informs the common law legal systems. If it did there would be prima facie a good justification for Posnerite analysis because the techniques of economics (a means by which rational human preferences may be maximised) and the technique of law (the practical application of these techniques of economics) would be sufficiently related.[3] This is a fundamental point. There are legal systems which may roughly be identified as utilitarian in function: democracies, for example, contain the notion consistent with utilitarianism of each person's being able to express his preferences for the way his life should be governed by virtue of the ballot-box. But there are other systems such as socialist legal systems which are not so easily associated with utilitarianism. Further, some totalitarian legal systems whose rules exist to preserve the values of a comparatively small group of people seem anti-

[3] There is a strong resemblance between Posner's basic approach and that of Pashukanis who conceived of "capitalist law" entirely in terms of contractual, and for Pashukanis therefore economic, relations.

utilitarian in character. In these sorts of legal system an economic analysis of the law in the sense in which it has so far been discussed must lack point.

Totalitarian and socialist legal systems apart, it is still not clear that the crude wealth-maximising utilitarianism referred to informs our own democratically based system. Is it true that the arguments of judges and lawyers are disguised economic arguments aimed at maximising wealth? Judges do not overtly speak in this way and many judicial arguments at least appear to take into account a dimension of individual autonomy quite independent of the dimension of wealth-creation. That is, it seems reasonable to expect the Posnerite analysis to be able to account for the belief of lawyers that individuals' claims to decisions that will not in the short or long run produce more wealth for society are nevertheless perfectly appropriate claims to make in legal argument. What is it then that attracts the economist of law to a wealth-maximising analysis of judicial decisions?

THE APPEAL OF JUDICIAL INSTITUTIONS BEING THE BEST WEALTH-MAXIMISERS

There are several attractions for economists in examining judicial decision-making in systems that are roughly classifiable as utilitarian. One is the attraction of efficiency. Judicial decision-making is largely incremental; in relation to society as a whole any one judicial decision does not usually have more than a marginal impact whereas legislation characteristically often has considerable impact. Mistakes are therefore less costly and their impact more efficiently dispersed. Furthermore, access to the courts and the resultant decision-making is much easier and faster than governmental intervention which could well include expensive petitioning and lobbying. It will be true that the decisions have less impact but the virtue will be that mistakes can be corrected with relative ease and with less cost. The courts then seem ideally placed in terms of a wealth maximising function to make marginal and incremental cost effective decisions the combined effect of which will be to maximise wealth overall within the legal system.

The Coase theorem

Another reason for supposing that courts are potentially efficient wealth maximising institutions arises from one of the tenets of economic analyst of law. It takes form in what has become known as the Coase theoren which is that the outcome of a perfect market transaction is independen of the legal rights of the parties.[4] A perfect market transaction is one wher (i) the parties bargain to mutual advantage or at least to the advantag of one and no disadvantage to the other (ii) the market is not distorte by, for example, the existence of a monopoly (iii) the parties have perfe knowledge and (iv) there are no transaction costs. The idea is that, whatev legal rights the parties have before going to the market, they will bargai for the most efficient result, being rational self-maximisers in the perfe market. For example, A lives next door to B's glue factory. B has the leg right to pollute the atmosphere. The theorem states that in the perfe

4 See Coase, "The Problem of Social Cost" (1960) 3 Journal of Law and Economics 1.

market, A and B will bargain to produce the most efficient result so that A will pay B (to reduce the pollution) the amount which will enable B to reduce the pollution and still make a profit. With a different assignment of initial rights whereby B is entitled to pollute only to the extent to which he pays compensation to A, B will reduce his pollution to the extent to which his payment to A does not prevent him from making a profit. Either assignment of legal rights in other words does not affect the efficiency of the outcome.

Now the theorem has fundamental importance for decision-making in the real and practical world where markets clearly do suffer defects, in particular in relation to the cost of the transaction. In the pollution case, for example, there will be many people in the position of A; and the costs of the negotiations leading to the separate bargains between these people and B, the costs of the formation of the contracts and the effective enforcement of the contracts will be considerable. The initial assignment of the legal rights in the real world of transaction costs will affect the efficient outcome of bargaining because in many cases all those in the position of A will be deterred by the transaction costs from entering into negotiation.

In order to produce efficiency the economic analysis of law proposes that judicial decisions in controversial cases be corrective of the inefficient allocation of resources where those are brought about by imperfections in the market. In other words the courts must supply a solution by imposing one which avoids otherwise impossibly expensive transaction costs. Such decisions are wealth-maximising because they bring about an allocation of resources in the most efficient way. In the case of the glue factory, the court simply bypasses the problem of transaction costs and thus "corrects" the actual market.

Both these reasons for finding courts particularly attractive as wealth creators are accidental in the sense that other institutions might have been able to impose such solutions. We can imagine a society where, in addition to courts, there are state "efficiency agencies". These would be institutions created by statute for the particular purpose of correcting markets and their prime task would be to impose solutions such as could have been imposed in the case of the glue factory. Although courts are seen to be an obvious institution whereby state-enforced decisions may be obtained the choice will be accidental unless it can be shown that the justification for these courts is that they are primarily wealth-maximising institutions. The Coase theorem also applies accidentally; it requires a situation of conflict where non-bargained solution may be imposed and it appears to follow that courts because they fit this description so nicely are primarily wealth-maximising institutions.

Autonomy of the individual

A second less accidental reason why economics and law appear to overlap has to do with questions concerning the autonomy of the individual. The notion of the perfect market implies the importance of the person as the rational self-maximiser for it is up to the negotiator alone to determine his preferences. It is contrary to the notion of negotiating that the negotiator has his preferences determined by anything other than his own particular

state of wealth or the outcome of the transaction. Put in another way the negotiator comes to the perfect market wholly autonomous over the question of his preferences. In the same way the litigant seeks to enforce his legal rights: the courts preserve the idea that individuals may make claims upon the state to attend to injustices suffered by them and that a litigant cannot simply be "bought off" where a decision not in his favour would have some beneficial social impact. This resemblance between courts and markets stems from similarities in certain utilitarian assumptions underlying both courts and markets in common law legal systems.

A refined version of utilitarianism is consistent with some conception of individual autonomy. One of the appeals of utilitarianism is its non-discrimination between people. In one important sense utilitarianism "does not take seriously the distinction between persons" but in another it is, more benignly, impartial between them.[5] One of the appeals of the principle of "the greater happiness of the greatest number" was that as many as possible were to benefit, no man counting for more nor less than any other.

The conception of individual autonomy in this refined version of utilitarianism may then act as a restraint on unqualified claims of majority decision. The principle that allows majority decisions to stand requires that those decisions be consistent with treating people impartially. This means, for example, that a majority decision to treat some individuals in a different way will be unjustified if it is based on anything other than impartial distinctions between these individuals and those individuals forming the majority, for example if it is based on racial differences.[6]

Similarly, the notion of impartiality is present in our judicial institutions The litigating parties approach the courts on the basis that an impartial assessment will be made and it is fundamental to the judicial process that long term considerations, or considerations concerning the relationship between what the State claims it has a right to do and what an individual claims he has a right to do, are each liable to be over-ridden. To stress this point: individual autonomy requires that individuals be treated or considered in a particular way even although the final decision might not be in the individual's interest.

The equivalent background assumption in economics is that, as previously discussed, the notion of individual autonomy is present in the market, for economists assume that in the perfect market individuals are present as autonomous bargaining beings. Indeed, the perfect market could not be instituted unless there were such beings to operate it[7] so that the

5 See Rawls, *A Theory of Justice* (1970) 27. It may be being a little benign to utilitarianism if utilitarianism cannot distinguish between persons it cannot be *impartial* between them. See Hart, "Between Utility and Rights" in *The Idea of Freedom* (ed Ryan 1979) 77. Professor Hart here says that utilitarianism's chief defect lies in "neglecting the separateness of persons".

6 See Dworkin, *Taking Rights Seriously* (1977) chs 8 and 12.

7 See Fried, *Right and Wrong* (1978) 100-104. Posner's view that the model of the market can be used to allocate rights to those individuals who value them most thereby defining what rights individuals have is therefore circular because the starting point – the market – itself presupposes a conception of rights. See Posner, "The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication" supra n 1.

idea of the perfect market presupposes some idea, although perhaps unanalysed, of individual autonomy.

Paretanism

This notion of market autonomy surfaces in the economists' idea of Paretanism[8] and in relation to the economic analysis of law it is important to distinguish the criteria of Pareto-superiority and Pareto-optimality, both of which relate to improvements in utility, from the criteria of wealth maximisation as used by the economists of law which are most frequently the Kaldor-Hicks criterion and various glosses upon that criterion.[9]

Paretanism makes great concessions to the notion of individual autonomy. It provides a criterion of what counts as maximising utility combined with a distributional criterion. Situation A is Pareto-superior to situation B if in situation A at least one of the parties is better off and neither of the parties is worse off; a Pareto-optimal situation on the other hand envisages the end of a possible chain of Pareto-superior moves whereby there is no further situation where one party would be better off without the other being worse off.

Paretanism provides a measure for marginal increases in utility. No one is worse off; at least one is better off: under the theory that the greatest number should be better off, the criterion must measure some increases in utility. And it achieves this at the same time as giving a polite nod in the direction of individual autonomy. Two rational self-maximisers approach the perfect market and come away with at least one of them better off and neither worse off. Here it seems very plausible to suppose that the perfect market achieves a perfect balance between the maximisation of overall (community) utility and individual autonomy.

The problem with Paretanism is that in the real world because of distortions in the market Pareto-superior situations occur with relative infrequency, the more usual situation being that where one party is left worse off after a transaction. Furthermore as a consequence of the existence of real markets there will be relatively frequent Pareto-optimal situations where no further move can be made because one party will be worse off. In practice it appears that the criterion of Pareto-superiority is unworkable despite its having a clear and pleasing ethical ring to it.

Wealth Maximisation as the Criterion of the Correct Decision

An alternative criterion of wealth-maximisation has been proposed by Kaldor and Hicks[10] which purports to surmount the practical difficulties in real markets. This is a *wealth*-maximising criterion as opposed to a *utility*-maximising one and it states that a decision or policy is wealth-maximising

[8] Coined after the Italian economist Vilfredo Pareto who wrote *A Manual of Political Economy* (1909).

[9] See, for example, Markovits, "Legal Analysis and the Economic Analysis of Allocative Efficiency" (unpublished paper prepared for the Oxford Centre for Socio-Legal Studies, 1982).

[10] The criterion is based upon two important papers: Kaldor, "Welfare Propositions of Economics and Interpersonal Comparisons of Utility" (1939) 49 Economic Journal 549 and Hicks, "The Valuation of Social Income" (1940) 7 Economics 105.

if the amount of wealth created by the decision is enough to compensate those who are left with less wealth after the decision. At base the criterion is Paretanism shorne of its distributional aspect and deprived of its direct reference to utility.

In the first place, a wealth measure must replace reference to utility because the extent to which one party is better off has to be measured against the extent to which the other party is worse off. Nevertheless, it should be seen that the reference to wealth as opposed to utility assumes that increases in wealth assume marginal increases in utility. Wealth, therefore, replaces utility with the background assumption either that wealth is valuable in itself[11] or, more plausibly, that wealth is a potential instrument for increasing utility.

Secondly, because the Kaldor-Hicks criterion lacks a distributional criterion all reference to individual autonomy is removed. This means that the step from Paretanism to Kaldor-Hicks is a very large one, although we now have a criterion for measuring whether judicial decisions are good (i.e. wealth efficient) which would work in practice (unlike Paretanism) to increase wealth. On the other hand, to achieve this step we have had to pay both the price of abandoning reference to utility (as opposed to wealth) and the higher price of sacrificing individual autonomy. And both these prices are especially high in terms of the Posnerite analysis of law because what was attractive about Paretanism in the law and economics field was its apparent drawing together of elements of autonomy and utility in both the market place and the court.

As a result, particularly because the autonomy element has been discarded, the analogy between markets and courts is much more difficult to draw. One can understand why a litigant would go to court if he knew that the court would attempt not to make him worse off by its decision; but why would he go to court if he knew that the basis of the decision was to produce more wealth for society? Such a decision may leave him worse off. Why would he go to court otherwise than simply as a hope that the cost-effective decision will fall to his favour? But this seems very unclear as a description of how litigants view their going to court. At least an explanation is required of why it is that litigants talk in terms of rights that are personal to them while a Posnerite might say that litigants have "rights" to the cost-effective decision being made. The latter do not seem correctly classified as "rights" at all.

Two further complications for the Posnerite analysis arise here. First, we should take the case of the litigant who feels that he has a right to a particular decision because there is argument in the case law which supports him and who is therefore aggrieved when a cost-effective decision is made against him. If the economic analysis of law is to be plausible then such a litigant ought not to feel aggrieved because his feelings of grievance can only arise from his having misunderstood the purpose of going to court. If in fact the decision is cost-effective then the litigant has no ground for feeling a grievance: the case law is assumed by the economic

11 An assumption, frequently made, which strikes me as lunatic. See Dworkin, "Is Wealth a Value?" (1980) 9 Journal of Legal Studies 191.

analysis of law to support the cost-effective decision being made and because it has been made the litigant's grievance has no basis in law.

Alternatively, it could be argued that the litigant's grievance is really about not having had a decision made in his favour; but that makes no more sense than saying that people are aggrieved when they fail to win lotteries (even when the stakes are as high as two to one). The point is that in the scheme of judicial decision-making envisaged under the Posnerite economic analysis of law the position of the litigants is accidental; the fall of the decision depends upon cost-efficiency and not upon the particular merits, rights, deserts or whatever inherent in either party's case. Judging here is, rather, miniature legislation whereby the parties have accidentally thrown up the particular situation sought to be legislated on.

The second complication is that this view of the legal process takes no account of how litigants, courts and lawyers treat adjudication. Any description of the judicial process must to a large extent refer to what actually happens in courts and this must to a large extent be dependent upon what judges, lawyers and litigants say and expect. It would be a major argument against the Posnerite economic analysis of law to show not only that courts did decide a significant number of cases which were not cost-effective but also that judges and lawyers did not talk in cost-effective terms.

Why are the mistakes that have been pointed out made? The major reason is that economics and law have an obvious common element because both disciplines are concerned with theories of choice and decision. On the question of which choices and which decisions to make, given certain initial assumptions or wishes, economics has a large contribution to make both at the pre-legislation stage and later at the point of interpretation of delimited areas of the law where a clear economic rationale is discernible. It is questionable, however, whether the economic analysis can and should extend any further; although some areas of tort (e.g. parts of nuisance) and contract seem to have an economic rationale, other areas of the law clearly do not (e.g. the criminal law of assault).

One important task to be undertaken before full-scale cost-effective criticisms are made of judicial decision-making within common law systems is to clarify whether such criticism would be consistent with the rationales of the various areas of the common law. This task appears to be one that the lawyer should not be happy to leave to economists alone.