

# LAW AND ECONOMICS IN LATIN AMERICA. SOME ETHICAL ISSUES RECONSIDERED

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## Abstract

In Latin America, law and economics scholarship is gradually finding its way into court decisions and legislative enactments, both with respect to an increasing tendency to assess the overall consequences of legal rules, in terms of a growing application of cost-benefit analyses, and in the form of more incentives-driven reasoning. Until today, however, the literature on the movement's normative foundations has failed to find common ground on how to justify its theoretical suppositions. This article illuminates this debate and provides an overview over some of the approach's most basic assumptions that relate to its positive and normative implications.

**Keywords:** *Law and Economics, Rational Choice Theory, Efficiency, Utilitarianism, Wealth Maximization, Consensus Theory, Pragmatism*

## I. INTRODUCTION

It has been almost two generations since Ronald Coase initiated the rise of law and economics in the United States. Despite the movement's resounding success both in scholarship and practice, most civil law jurisdictions have remained impervious to the adoption of the economic analysis of law as an integral part of their methodology—even if a number of significant scholarly contributions originated from the civil law world.<sup>1</sup> At least in Latin America, however, there is a growing tendency to integrate economic reasoning into legal thought, as a number of recent Argentinian and Brazilian court decisions and legislative enactments attest.<sup>2</sup> This rising transformation notwithstanding, deployment of economic reasoning remains scarce in most civil law jurisdictions. This is due, in part, to a lack of agreement about the movement's normative foundations. This article illuminates this debate and provides an overview over some of the approach's most fundamental assumptions

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1 Some of the most important works include ASSMANN, KIRCHNER and SCHANZE (1993); SCHÄFER and OTT (2005); TOWFIGH and PETERSEN (2017).

2 For an overview of these developments see IRIGOYEN-TESTA (2015); PARGENDLER and SALAMA (2015).

that relate to its positive and normative implications. Specifically, this article provides a survey of central issues confronting contemporary law and economics scholarship and blends the most contentious issues to equip the reader with a comprehensive understanding of its underlying suppositions.

The economic analysis of law addresses two principal issues about legal rules—one that is descriptive, and another that is normative. The descriptive issue relates to the effects, i.e., the consequences of legal norms and judicial decisions in reality. For example, the economic analysis of law asks how car accident liability rules affect the number and severity of car accidents, the compensation of victims of car accidents, and the parties' litigation costs to enforce liability.<sup>3</sup> The normative issue evaluates the social desirability of legal rules from an economic perspective and makes statements about how the law should be designed to achieve a socially desirable result.<sup>4</sup> While particular areas of law, such as antitrust, business corporations, and the regulation of economic activity more generally have long been subject to economic analyses, since the 1960s, proponents of the economic analysis of law have expanded their scope of research into almost all areas of the law, including, for instance, criminal, evidence, and family law.

This expansion is closely connected with research conducted by a number of distinguished American economists. In 1960, Ronald Coase demonstrated that the allocation of property rights through the legal system will only affect the result of private bargaining in a world of high transaction costs.<sup>5</sup> Otherwise, private bargaining will always lead to a Pareto efficient outcome—irrespective of the manner in which the law allocates individual property rights. In 1965, Armen Alchian presented a comprehensive economic theory of property rights.<sup>6</sup> In 1968, Gary Becker extended the domain of the economic analysis of law to a wide range of nonmarket behavior such as crime, racial discrimination, family organization, and drug addiction.<sup>7</sup> In the 1970s, Guido Calabresi and Douglas Melamed published a comprehensive treatment of the efficient distribution of risks resulting from harm.<sup>8</sup> In 1971 and 1975, William Landes and Richard Posner wrote a series of foundational articles on the economic analysis of the criminal process and the court system.<sup>9</sup> Richard Posner is the author of the most significant textbook on the economic analysis of law, which, in 2014, appeared in its ninth edition.<sup>10</sup>

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3 CALABRESI (1970).

4 CALABRESI (1961).

5 COASE (1960).

6 ALCHIAN (1965).

7 BECKER (1968).

8 CALABRESI and MELAMED (1972).

9 LANDES and POSNER (1975).

10 POSNER (2014).

Under the economic approach to the analysis of law, the assessment of social policies and legal rules is undertaken with respect to a stated measure of social welfare. A particular legal arrangement is deemed to be superior to another if the first arrangement produces a higher level of the stated measure of social welfare. From this it follows that the social welfare criterion under consideration determines to a considerable extent which legal rule may be optimal. If the desired social goal were simply to bring about a decrease in the number of car accidents caused, the best rule might embrace a regime in which causing car accidents is severely punished. However, if the desired social goal also includes the benefits that citizens obtain from driving cars, the best rule would have to be designed differently.

The most widely employed measure of social welfare is presumed to be a function of individual utilities, which, in turn, may be a function of anything about which individuals care (e.g., tangible or intangible needs, other-regarding pleasures, motives of fairness to be satisfied, etc.).<sup>11</sup> For a number of practical reasons, standard economic analysis, however, focuses on fairly simple measures of social welfare that rarely take into account the distribution of utilities such as the distribution of income or the distributive effects of the choice of legal rules. Furthermore, for analytical convenience, notions of fairness and morality, such as an insistence that a wrongdoer makes restitution to their victim for the harm endured, are ordinarily excluded from the analysis.<sup>12</sup>

The economic analysis of law attaches significant importance to the idea that individuals are acting rationally, considering all conceivable and foreseeable consequences of their choices.<sup>13</sup> By describing individual behavior, the economic analysis of law emphasizes the use of stylized models and of statistical, empirical tests of theory in describing individual behavior. As a result, legal sanctions act as prices that make certain types of behaviors more expensive as compared to others. Efficient, in economic terms, are consequences that increase social welfare; inefficient are those that decrease it.<sup>14</sup>

Against this backdrop, the economic analysis of law has the potential to reduce the complexity of legal rules and increase predictability. Based on positive rational choice theory and on the normative criterion of allocative efficiency, legal and economic scholars may find common ground on a whole range of issues that are relevant to both fields. To the extent that legal rules become more predictable based on rational choice assumptions, the rules' conclusions will be amenable to empirical testing and falsification.<sup>15</sup> This may render it possible for the law to develop into a discipline that exhibits properties of modern scientific inquiry. The economic analysis of law explains the effects of legal rules by assessing their *economic efficiency* and

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11 SHAVELL (2004), p. 2.

12 SHAVELL (2004), pp. 3-4.

13 BECKER (1976).

14 BECKER (1968).

15 POSNER (2014); SCHWARTZ (2015).

by predicting, based on this criterion, which laws should be promulgated. From this follows the premise that legal rules that allocate resources most efficiently enjoy a comparative advantage over laws that are based on alternative criteria such as fairness or equity, because efficient legal rules prevail within the market mechanism's process of selection.<sup>16</sup>

A frequently employed concept of efficiency by scholars is *Pareto efficiency*. A legal rule is Pareto efficient if it could not be altered so as to make one person better off without making another person worse off. A somewhat thinner conception of efficiency is *Kaldor–Hicks efficiency*. A legal rule is Kaldor–Hicks efficient if it were made Pareto efficient given that some parties compensated others for their loss. Most law and economics scholarship thus operates within a neoclassical welfare economic framework that allows policymakers to evaluate which rules increase social welfare. All actors within a legal system—not just legislators, but also administrative agencies and courts—are required to make decisions that increase social welfare or at least will not diminish it.

## II. ASSUMPTIONS

Addressing the normative issues on which the economic analysis of law is based calls for an examination of its positive assumptions first. The most essential assumption that the economic analysis of law makes is grounded on *rational choice theory*. Rational choice theory presumes that individuals always strive to maximize their utility (or happiness) but does not specify where individual preferences or wants originate; rational choice theory only mandates a consistent ranking of the individual's alternatives. There is thus nothing irrational in one individual preferring an apple to an orange and another preferring the opposite; however, it would be irrational for one individual to prefer an apple to an orange on one occasion and to prefer an orange to an apple on another, without anything else having changed.<sup>17</sup> Based on this assumption, proponents of rational choice theory are able to predict the outcomes and patterns of individual choices. While they refrain from describing any decision-making process itself, proponents of rational choice theory assume how individuals behave under a particular set of conditions. They do not, however, make any ethical or normative statement about how individuals ought to act.<sup>18</sup>

Most often, rational choice theory is grounded on the additional assumption that individuals are self-interested so that they behave as if a comprehensive balance of costs and benefits led them to arrive at an act that maximized personal advan-

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16 PRIEST (1977).

17 SEN (1997), p. 55. Even though the concept of rationality used in rational choice theory is narrower than the colloquial understanding of it, individual behavior is deemed to be rational according to proponents of this theory if that behavior is geared toward a particular goal, is reflective (evaluative), and consistent across numerous choice situations and across time. Irrational, by contrast, is behavior that is arbitrary, impulsive, unevaluative (i.e., adopted by imitation), or conditioned.

18 For a critique of this assumption SEN (1997), p. 55.

tage. Rational choice theorists do not purport to claim that these assumptions are an accurate description of the real world. They make these assumptions simply to help formulate clear and falsifiable hypotheses about individual and collective behavior.

A second fundamental assumption of the economic analysis of law is based on the criterion of *allocative efficiency*. This criterion enables analysts to assess if legal rules and decisions are, in fact, economically efficient. While the early neoclassical approach attempts to measure, by observation or by judgment, an individual's utility that results from a change in social or economic conditions (and thus assumes interpersonally commensurable utility functions),<sup>19</sup> proponents of the new welfare economic approach dispense with cardinal measures of utility, replacing efficiency with an ordinal utility function that merely asks which option may be "better," "worse," or "equally preferable" to another.<sup>20</sup>

## 2.1. The Economic Model of Behavior

### 2.1.1. The Scarcity of Resources

The economic analysis of law proceeds from the fundamental economic problem of having ostensibly infinite human wants in a world of limited resources. The idea of scarcity states that there are never enough productive resources to satisfy all human wants and desires. For individual agents, this notion of scarcity entails making a tradeoff, i.e., sacrificing something to obtain (more of) the scarce resource that is requested. One way to allocate scarce resources is through competition between individuals who desire such resources so that market prices coordinate—based on an individual's willingness to pay—the allocation of scarce resources.<sup>21</sup> The condition of scarcity makes the study of human behavior, in particular the choice—or the alternative—between scarce resources, the central unit of analysis: as productive resources are limited, humans have to choose one option and forgo another. This phenomenon is referred to as opportunity cost: presuming the best available choice is made, i.e., choosing an apple over an orange, the opportunity cost of selecting an apple is the cost incurred by not being able to enjoy the benefit from choosing an orange.<sup>22</sup> In order to evaluate which alternative provides an individual with the highest benefit to themselves, the economic analysis of law employs the law of diminishing marginal utility: when an individual consumes more of a specific option (e.g., bread), the value of the consumed good (bread) diminishes and the individual starts preferring another (e.g., cheese). The fall in marginal utility, as consumption of one good increases, therefore determines to a significant extent which alternative the individual will choose.<sup>23</sup>

19 MARSHALL (1920), pp. 58-90; PIGOU (1932), pp. 42-43.

20 ROBBINS (1937), pp. 138-139; ARROW (1951), p. 9; de SCITOVSKY (1951), pp. 304-305; LITTLE (1957), p. 52.

21 VON HAYEK (1945).

22 BUCHANAN (1991).

23 MENGER (1950), p. 187; GOSSEN (1983).

### 2.1.2. The Rationality Principle

The condition of scarcity implies that human behavior must tend to achieve a particular benefit—a certain degree of want satisfaction with the lowest possible use of a scarce resource or with a specific use of resources. According to economic theory, this condition in turn implies that individual action follows the principle of utility maximization.

Utility maximization entails that individuals choose from several alternatives the one that maximizes their own benefit. To this extent, individual decision-makers do not care about the welfare of others; however, even utility-maximizing individuals may behave altruistically if altruistic behavior promotes, at least to some extent, an individual's own benefit.<sup>24</sup>

It further follows from the utility maximization principle that individuals are *capable* of acting to their own advantage, i.e., to estimate and assess their sphere of influence so as to maximize their own benefit. At the level of the individual, this implies that individuals choose—based on complete and transitive preferences—the outcome they prefer most. If an individual has a choice between options X and Y, the individual can then *state* whether X is preferred to Y or whether Y is preferred to X or whether both are equally preferred. Each individual is able to *rank* the elements of their choice in an internally consistent manner or to state whether they are indifferent as to the given alternatives. Transitivity occurs if the individual prefers X to Y and Y to Z, and, as a consequence, also prefers X to Z.<sup>25</sup>

A particular decision-making context is thus generally described by two distinct conditions that involve preferences and constraints. A *preference* describes an individual's internal attitude, their evaluative judgment toward a particular set of objects. Preferences are generated by decision-making processes, such as conscious or subconscious choices, and can be affected by an individual's surroundings and education, social and cultural background, or religious beliefs.<sup>26</sup> *Constraints* refer to external stimuli that provide an incentive to induce a particular behavior.<sup>27</sup> The economic model of individual behavior explains behavioral changes primarily, if not exclusively, in response to external stimuli, i.e., in response to changes in constraints. Preferences are thought to be stable and provide no explanation for changes in individual behavior.<sup>28</sup> For example, if a consumer is given a choice between products A and B, a constraint may result from the individual's available income and from the prices of the goods that have been offered to them. Further constraints may include the amount of time available for consuming the good (e.g., with respect to performing a hobby), legal rules (e.g., when consuming illegal drugs), or ethical norms (e.g., with

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24 FEHR and SCHMIDT (2003).

25 SEN (1997), p. 58.

26 KUENZLER and KYSAR (2014).

27 COOTER and ULEN (2016), pp. 12-14, 18-20, 20-24.

28 KREPS (1990), p. 25.

respect to the consumption of products manufactured by children in developing countries).<sup>29</sup> Generally speaking, the relevant constraints that determine individual behavior are relatively easy to define. An individual's (internal) preferences, however, are often rather difficult to gauge. Consequently, economic theory tends to assume that individual preferences are more stable than are external constraints, i.e., that they are less often subject to change and are more difficult to control.<sup>30</sup>

In this manner, the economic analysis of law allows the prediction of changes in individual behavior *as a result of changes in individual constraints*. Such predictions are potentially falsifiable. The empirical test on which a prediction is based consists in a comparison between the predicted and the actual behavior as it is observed in reality.

### 2.1.3. Methodological Individualism

The economic model of behavior examines the world from the point of view of the individual. This view is based on the supposition that there is no objective method to measure absolute individual utilities and to compare such utilities interpersonally (e.g., whether product A affords person A with 100 units of utility and person B with 200 units of utility, while product B affords them each only 50 units of utility). At the most, individual utility can be measured and compared ordinally, i.e., in relation to measures such as “better,” “worse,” or “equally preferable.”<sup>31</sup>

Following on from this, legal norms are seen as a result of a cooperation between individuals who in turn decide on what, how, and when to consume, based on their own individual utility functions, and individuals cooperate with other individuals solely to their benefit. The economic analysis of law does not recognize any collective entity that could not be derived from the utility functions of the community's individuals themselves. Collective decisions always are the outcome of an aggregation of individual choices rather than of discrete actions of a collective. Put differently, collective utility functions are only recognized if they can be derived from individual wants.<sup>32</sup>

## 2.2. The Economic Efficiency Rationale

### 2.2.1 Pareto Efficiency

Italian economist Vilfredo Pareto proposed a simple decision-making criterion to evaluate the desirability of different states of resource allocation in a society.<sup>33</sup> Due to its widespread application in economics and other disciplines, the concept has come to be known as *Pareto efficiency*. Pareto efficiency is a state in which society's resources are allocated so that it is no longer possible to make any one individual

29 HAUSMAN (2012), pp. 57-74.

30 But see, e.g., GINTIS (1974); BOWLES (1998).

31 ROBBINS (1938).

32 STIGLER and BECKER (1977).

33 For an English translation see PARETO (2014).

better off without making at least one individual worse off. For example, state A is to be preferred to state B if at least one individual prefers A to B and no other individual prefers B to A. This means that all other individuals also prefer A to B or are indifferent as to whether they prefer A or B. Any change to a different resource allocation in a particular society that would render at least one individual better off without making any other individual worse off constitutes a Pareto improvement. A social state is *Pareto optimal* if it is impossible to make any further Pareto improvements.<sup>34</sup> Pareto efficiency thus simply requires that individuals value different states of resource allocation in terms of “better,” “worse,” or “equally preferable,” not whether they value, say, state A as being twice or three times as desirable as state B. Pareto efficiency is in other words based on an ordinal measure of utility.

Note that Pareto efficiency does not involve a “just” society in any strict meaning of the term. Even a society in which wealth is created by producing and accumulating resources through forced labor can be Pareto efficient, particularly if the only improvement of the state of resource allocation of individual workers can be achieved by worsening the state of resource allocation of the employers.<sup>35</sup>

### 2.2.2. Kaldor–Hicks Efficiency

Pareto efficiency requires that no individual will be made worse off through a change to a different resource allocation. Each member of a society is given the power to veto potentially adverse measures. However, in practice, it is rarely ever possible to take any social action, such as a modification in economic policy, without making at least one person worse off. Even voluntary exchanges may result in a disadvantage to third parties and may, in consequence, fail to be Pareto efficient. The stringency of this concept thus considerably reduces the scope of government action in real-world settings. Policies that redistribute income could scarcely be enforced. Taking this deficiency into account, the notion of Pareto efficiency required a modification to make it applicable to a wider range of circumstances.

At the end of the 1930s, English economists Nicholas Kaldor and John Hicks proposed a concept that captured some of the intuitive appeal of Pareto efficiency but that allowed for the satisfaction of less stringent requirements. According to Kaldor and Hicks, it ought to be sufficient if those who are made better off could hypothetically compensate those that are made worse off and a Pareto efficient improvement—a net increase in welfare—would still result.<sup>36</sup> Following on from this, a situation is said to be *Kaldor–Hicks efficient* if those who are made better off value their gains more highly than the losses suffered by those who are made worse off. A Kaldor–Hicks improvement thus simply requires that those who benefit from a particular change of resource allocation could compensate those that are harmed by it, not that compensation is actually paid. If actual compensation were required under the criterion of Kaldor–Hicks efficiency, this would ultimately amount to achieving a

34 SHAVELL (2004), p. 293.

35 SEN (1993).

36 HICKS (1939); KALDOR (1939).



Pareto efficient result. Under the concept of Kaldor–Hicks efficiency, by contrast, an improvement may actually leave some people worse off. By contrast, Pareto efficiency requires that every actor involved is better off or at least that no one actor is harmed.<sup>37</sup>

Kaldor–Hicks efficiency also dispenses with cardinal utility measures and interpersonal utility comparisons. Assuming, for instance, that a change of state A to state B allows entrepreneur X to build four new factories and to acquire a new vehicle, and, as a result, entrepreneur Y loses an employee, the reallocation from state A to state B is said to be Kaldor–Hicks efficient if Y was indifferent toward state A, given that X either transfers the new vehicle to Y or if Y can build the factories instead of X. Y would be indifferent toward the initial state and would still gain an advantage. No cardinal utility measures and interpersonal comparisons of utility are required to determine this result. However, Kaldor–Hicks efficiency ordinarily involves a comparison of the costs and benefits of a particular change in resource allocation in monetary terms. Here, the affected parties no longer need to be asked under which circumstances they feel indifferent toward a change. An allocation is therefore Kaldor–Hicks efficient *if its benefits outweigh its costs*. To this extent, Kaldor–Hicks efficiency merely requires that a change from one state to another results in a benefit for society overall, so that those who are harmed could then be compensated.

### 2.2.3. Kaldor–Hicks Efficiency as an Auction Rule

Richard Posner relied on the concept of Kaldor–Hicks efficiency to articulate an auction rule: assigning a legal entitlement such as the right to construct, or to refuse to construct, an airport, for instance, to the party who would have purchased it absent transaction costs ensures that the entitlement will be secured by the highest bidder.<sup>38</sup> Such a rule guarantees that the party with the highest willingness to pay obtains the entitlement and that this party would be in a position to compensate the loser and still benefit from its assignment. Posner’s auction rule does not require actual compensation by the highest bidder and does not guarantee that the outcome of the entitlement’s allocation is Pareto superior. The rule instead intends to simulate an efficient market, which in turn results in a Kaldor–Hicks efficient and Pareto optimal state. However, Posner’s auction rule fails to account for the fact that an agent’s willingness to pay not only depends on an individual’s utility function, but also on their *solvency*.<sup>39</sup> Viewed from this perspective, Kaldor–Hicks efficiency tends to penalize the poor while favoring the rich.<sup>40</sup>

In Posner’s view, assignment of legal entitlements can best be understood as attempts to maximize wealth. The concept of wealth maximization states that state A is preferred to state B if the *wealth* of a society is higher in state A than in state B.<sup>41</sup>

37 BAUMOL (1977).

38 POSNER (2014).

39 Further complications with willingness to pay values arise in light of recent social science work on how individuals decide, see KUENZLER (2017a)

40 COLEMAN (2003), pp. 87–94.

41 POSNER (1979).

In its practical application, the wealth maximization principle ordinarily generates the same outcomes as the Kaldor–Hicks efficiency criterion. For the latter, it is sufficient if winners can only hypothetically compensate losers. Collective decisions should be made so that the total amount of wealth generated through a reallocation of resources is maximized for each single individual; a corresponding change in resource allocation is Kaldor–Hicks efficient. The economic analysis of law therefore is largely based on the concept of Kaldor–Hicks efficiency.

### III. EFFICIENCY AS A NORMATIVE PRINCIPLE

The economic analysis of law represents an important tool to assess the consequences of legal rules and makes predictions about how individual agents behave in response. Its positive orientation and its evaluation of social policies with reference to a stated measure of economic efficiency affords central importance to the economic function and effects of legal rules.

Against this backdrop, legal scholars and practitioners have asked if wealth maximization—or efficiency—is a goal that lawmakers and judges *ought to* pursue. After all, it is far from certain whether a society with more wealth is “better,” or will be “better off” than a less wealthy one.<sup>42</sup> What is more, law is ordinarily the result of numerous social, political, and historical influences. Economic efficiency may be but one criterion for assessing the consequences of legal rules, however, it may not be the only one. Equity, fairness, rule of law principles, and individual rights are values that play a significant part in organizing human societies as well.<sup>43</sup> Proponents of the economic analysis of law have held, however, that social wealth maximization should be the ultimate—or even the only—goal for a society to pursue.<sup>44</sup> For what reasons, then, should economic efficiency be the main principle underlying a legal system?

An obvious first set of reasons can be found in utilitarian theory. Utilitarianism is an ethical concept that has its roots in the works of Jeremy Bentham and John Stuart Mill. Particularly in the Anglo-Saxon world, through its further development by Henry Sidgwick, it belongs to the most important philosophical movements of the present day. Modern economics, especially welfare economics, was coined by utilitarian thinking. And because welfare economic theory has emerged from utilitarianism, utilitarianism plays an important part in the debate on the normative foundations of the economic analysis of law. However, utilitarianism is not the only philosophical position on which scholars have tried to base their justifications of economic efficiency. Utilitarianism has been subject to considerable philosophical and ethical objections. An alternative attempt to justify the economic efficiency rationale is grounded on John Rawls’ *Theory of Justice*. Finally, in more recent times, attempts have been made to rationalize the economic efficiency goal on pragmatic considerations.

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42 DWORKIN (1980a).

43 CALABRESI (1991).

44 POSNER (1980).

### 3.1. Utilitarian Justification for Maximizing Economic Efficiency

In his book *An Introduction to the Principles of Morals and Legislation*, Jeremy Bentham set forth the idea that the moral correctness of actions depends on the positive or negative qualities of their consequences.<sup>45</sup> From the point of view of utilitarianism, the correctness of an action is assessed based on its outcomes. In deontological ethics, by contrast, it is not the consequences of actions that make them right or wrong but actions may be “good in and of themselves,” i.e., without qualification, particularly, without regard to their consequences. According to utilitarianism, actions cannot, however, be “intrinsically” good without regard to their outcomes. Utilitarianism always depends on one or another doctrine of value. Put differently, utilitarianism presupposes a value system based on which it is possible to assess whether a particular consequence is “good” or “bad.”<sup>46</sup>

Classical utilitarianism holds that the common goal of individual action consists of increasing the happiness of as many people as possible.<sup>47</sup> In its primary and broadly accepted sense, the common good implicates the sum of each individual’s interests in a particular society. If the common good is comprised of the sum of each individual’s happiness, a simple decision-making criterion ensues based on which it becomes possible to determine which of two states that favor or discriminate against different individuals is to be preferred. For instance, when evaluating if it makes sense to move from a particular state A to B, one simply needs to subtract from the favored individual’s benefit the discriminated-against’s harm. If the difference is greater than zero, the change is justified. Any action that increases the common good in this way is warranted from the point of view of utilitarian theory.

Looking at the structural features of utilitarianism allows us to glimpse a number of similarities that this doctrine shares with the economic analysis of law. Both theories evaluate the desirability of legal rules based on their outcomes (utility maximization or economic efficiency, respectively). The issue of whether a particular goal in fact is achieved simply depends on the outcome that legal rules will have in the future. What is more, both the economic analysis of law and utilitarianism proceed from commonly shared assumptions: both theories result from the motivations and actions of individual agents. There is no collective entity, or goal, independent of the preferences of individual agents. In assessing the consequences of legal rules both theories are universalist, i.e., they consider the preferences of all affected individuals in the aggregate.

Classical utilitarianism, so-called act utilitarianism, is focused on helping individuals to choose the right action. Act utilitarianism asks what the consequences of a particular *act* are in any given situation. To rescue the theory from a number of its more trenchant criticisms, act utilitarianism came to be modified so as to afford a central role to *rules*. The essential difference between act and rule utilitarianism is

45 BENTHAM (1962).

46 PARFIT (1986); NAGEL (1989).

47 BENTHAM (1962).

that while act utilitarianism holds that an action is right if it maximizes utility, rule utilitarianism states that an action is right if it conforms to a general rule that maximizes utility. Under rule utilitarianism, it is not a particular act but a particular rule that is evaluated by its consequences. The question is thus what would follow from a single action if *everyone* did the same. Put differently, rule utilitarianism is based on the principle of generalization. An act from which bad consequences follow or the general performance of which results in bad consequences should not be performed. In that manner, rule utilitarianism corresponds with our intuitive judgment that moral behavior should be assessed in conformity with common rules. We employ this intuition in our everyday moral considerations and deliberations. Time and time again we hear statements such as: “What is supposed to happen if everyone acted in this manner,” or “think about the consequences if everyone behaved in this way.”<sup>48</sup> Equally, the economic analysis of law assesses legal rules on the basis of a general criterion. It asks whether legal rules—or judge-made decisions—are in line with general principles.<sup>49</sup>

### 3.1.1. The Wealth Maximization Principle

The utilitarian cost-benefit calculus differs markedly from the Kaldor–Hicks efficiency criterion on which the economic analysis of law is based. While *economic efficiency* is at the heart of the economic analysis of law, utilitarianism compares the *utilities* of individual agents. Admittedly, both utilitarianism and the economic analysis of law aim at increasing a particular social function. Both, however, assume a distinct standard of what ought to be right, what should be wrong or what is considered obligatory.

The most important difference between the economic efficiency calculus and the utility principle is that the former evaluates social change solely in monetary terms. In his essay “Utilitarianism, Economics, and Legal Theory,” Posner defends this conception as a moral counterpart to utilitarianism.<sup>50</sup> In so doing, Posner attempts to provide a sound philosophical basis for the economic efficiency rationale. But how convincing is the corresponding philosophical position itself? In approaching this issue, the focus of attention must be on whether the goals of maximizing economic efficiency and individual utility are strictly identical.

### 3.1.2. Differences between the Utility Principle and Economic Efficiency

A first difference between the promotion of economic efficiency and maximizing individual utility is that monetary units are not necessarily identical to individual utilities. This becomes most evident when considering the law of diminishing marginal utility. In its most general form, the law of diminishing marginal utility states that when an individual increases consumption of a particular good or service, while holding consumption of other goods and services constant, there is a decline in the additional satisfaction some individuals gain

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48 For an overview see SCANLON (2003), pp. 26-41.

49 POSNER (2014).

50 POSNER (1979).

from consuming one more unit of that good or service. Hence, the utility of any additional unit of income is smaller than the unit of income a person has already gained. Assuming for reasons of clarity that all people possess the same utility function, it is clear that the effects of an efficiency-oriented legal policy on the overall level of utility in society depend on the extent to which changes occur and with whom they occur. If someone loses their entire monthly income of \$3,000, the person's loss in individual welfare is greater than if the same person's income decreases from \$10,000 to \$7,000. Put another way, according to the Kaldor–Hicks efficiency criterion, a change in resource allocation to the extent that 1,000 people gain \$200 and one person suffers a damage of \$50,000 is efficient since the same person could be compensated by the 1,000 people. Measured in individual utilities, the loss in individual welfare of the affected person may, however, be higher than the individual utilities the 1,000 people gain. The marginal utility of a given change of \$200 may be minimal if any of the winners are comparatively wealthy. On the other hand, the loss in utility resulting from a \$50,000 damage may, by contrast, be high if the harmed person is very poor.

Introducing weighting factors into any such calculation could alleviate the problem of discounting the law of diminishing marginal utility. Depending on whether losses and gains are incurred by high- or low-income recipients, such losses and gains could be weighted differently, by, for instance, devising income districts where changes in low-income districts are multiplied by a high factor and changes in high-income districts are multiplied by a low one. Posner appears to assume the introduction of such a weighting system when postulating that, in principle, wealth maximization is not pecuniary in nature even though money is used as a unit of measure.<sup>51</sup>

But even the introduction of weighting factors cannot eliminate the difference between economic efficiency and utility: welfare economics is concerned with utility only insofar as utility can be measured in monetary terms. Utilitarianism, however, assumes that the pleasure derived from being *wealthy* is only one among a few. Utility is a complex phenomenon exhibiting numerous facets and features. Its complexity is most evident in the work of John Stuart Mill.<sup>52</sup> Mill's critics disapproved of utilitarianism because the multiplication of hedonic pleasures took center stage in formulating its underlying theory and failed to provide an evaluative basis for the distinction between ordinary and higher-order pleasures.<sup>53</sup> However, both Bentham and Mill presumed that the pleasures of the intellect, of our feelings and imagination, and of "moral sentiments" on the whole are more valuable than others.<sup>54</sup> By so doing, the notion of utility in Bentham's and Mill's doctrines employs higher faculties and puts an emphasis on issues such as education as well.

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51 POSNER (1979), p. 120; POSNER (1995), pp. 99-101.

52 MILL (1860); MILL (1863).

53 See MACKIE (1977).

54 BENTHAM (1962); MILL (1863).

### 3.1.3. Consequences for the Economic Analysis of Law

On close examination, it seems difficult to justify the economic efficiency goal based on rule utilitarianism. From the point of view of utilitarianism, legal rules that simply aim at increasing wealth in a society are incomplete. Plain utilitarianism, however, merely states that individual acts should be evaluated based on their consequences. To evaluate these consequences, a theory is required on the basis of which something is of “value” so that it can be referred to as being “good” or “bad.” Only on the basis of such a theory can the usefulness of an act be determined. The theory chosen is ultimately irrelevant. Utilitarianism refrains from prescribing a criterion that allows for a rational selection among competing value systems.

Focusing on the *theoretical structure* of utilitarianism therefore renders the contrast between efficiency and utility less explicit. After all, the usefulness of a legal system that aims at maximizing economic efficiency is determined to a considerable extent by the attractiveness of utilitarianism as a philosophical position—irrespective of the value theory ultimately chosen.

## 3.2. Evaluating Utilitarianism

### 3.2.1. The Problem of Quantification and of Interpersonal Comparisons of Utility

Utilitarianism assumes that a cost-benefit calculus exists based on which one can measure and compare individual utilities. However, interpersonal comparisons of utility pose a problem insofar as there is no external measure for (and thus no comparability of) individual utility: how can an individual’s satisfaction gained from a particular act be assigned to some units of utilities and how, as a result, can a relationship between the utilities of different options that distinct individuals face be made—adding or subtracting the utilities of the consequences suffered by those individuals? In whatever way “utility” is defined—as intensity or magnitude of individual preferences, as expected or actual gratification, as happiness or satisfaction—the issues that arise as a result of the problem of interpersonal comparisons of utility remain.

At first sight, this issue hardly seems relevant for the economic analysis of law since Kaldor–Hicks efficiency requires that different options be ranked solely in terms of “better,” “worse,” or “equally preferable.” Here, there is no problem of quantification, and interpersonal comparisons of utility are rendered obsolete. *In practice*, however, the benefits and costs that result from a particular action are measured in monetary terms. In turn, Kaldor–Hicks efficiency is applied just as an ordinary cost-benefit analysis would be. Consequently, cardinal measures and interpersonal comparisons of utility are inevitable, at least if one concludes that a positive monetary result from a change in legal rules entails an increase in utility overall. How should one otherwise know for certain that a loss of \$1,000 resulting in a decrease in utility for A compensates the increase in utility that person B experiences from gaining \$1,200? On close examination, as this example illustrates, a utilitarian justification of an efficient legal system cannot dispense with such a calculation. The introduction of Kaldor–Hicks efficiency therefore fails to solve the problem of interpersonal comparisons of utility.

### 3.2.2. The Problem of Distribution

Utilitarianism further fails to be concerned about the distributional consequences of legal rules. As long as the sum total of happiness or the sum total of wealth in a society remains constant, utilitarianism is indifferent toward any other distribution of happiness or wealth. A lower level of happiness, or less wealth, of person A may be compensated by a higher level of happiness, or more wealth, of person B.<sup>55</sup>

This holds true for a strict efficiency-oriented view as well. It might thus even be justified in a society geared toward maximizing economic efficiency to hold some people as slaves when at the same time efficiency would increase aggregate social welfare. However, proponents of utilitarianism might object that free people work more efficiently than people who are being held as slaves. Slaves could buy freedom on credit and pay off their debts from the surplus they generate through their labor. Slavery, even on a utilitarian view, should thus be abolished.<sup>56</sup>

### 3.2.3. The Problem of Aggregation

An additional point of criticism concerns the tension between individual preferences and the utility principle. This tension arises from the principle of preference autonomy and the concept of aggregating utility on which utilitarian ethics is based. According to the former, utilitarianism allows each individual to develop and follow their own wants. From the point of view of the state, however, individual acts are assessed solely with respect to the manner in which they affect the sum total of all individual utilities. Here, the individual solely counts as part of the whole. The focus is not on individual preferences or utilities but on a sum total that comprises the addition of happiness or pleasures across persons. Strictly speaking, from a utilitarian point of view, individual preferences are only a means to an end; they are instrumental in character to the extent that they serve the realization of a collective goal—the maximization of overall social utility.<sup>57</sup> Such an understanding of individual preferences also fails to pay due regard to the function and significance of individual rights, which becomes particularly important under circumstances where a majority oppresses a minority or individual actors. It is thus contentious whether a theory with such far-reaching consequences may legitimately resort to a philosophical position in which the basis of individual rights is doubtful. Even classical proponents of utilitarian thought were concerned about the state of inalienable individual rights. Mill, for instance, in his book *On Liberty*, vehemently defended the idea of individual freedom of action.<sup>58</sup> Later on, the objection that utilitarianism fails to take seriously individual rights came to prominence with John Rawls' *Theory of Justice*.<sup>59</sup>

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55 DWORKIN (1980b).

56 BENTHAM (1962).

57 POSNER (2014).

58 MILL (1860).

59 RAWLS (1999).

### 3.3. Consensus Theory and the Justification of Economic Efficiency

Due to the above discussed, weaknesses of utilitarianism, attempts have been made to justify the goal of maximizing economic efficiency based on consensus theory, an entirely different philosophical tradition of conceptualizing utility and social welfare. Social contract theory—the vantage point that individuals' moral and political obligations are contingent upon an agreement among them to organize the society they inhabit—is given its first comprehensive justification by Thomas Hobbes and subsequently by Jean-Jacques Rousseau, Immanuel Kant, and John Rawls, among others, and ensuing attempts to rationalize social arrangements, or “principles of justice”, on contractual grounds.

Consensus theory found its way into classical welfare economic thinking through the work of Pareto. As stated above, Pareto efficiency holds that a particular resource allocation is superior if at least one person in a society is made better off without making any other person worse off. Pareto efficiency uses something quite like a social contract argument to explain different social states. In particular, Pareto superiority entails that individuals are unable to pursue their own goals without respecting the individual rights of others because everyone who is affected by a particular change is required to consent to it. Every individual is recognized as an agent with its own rights and responsibilities, rather than as an instrument through which the welfare of others is maximized.<sup>60</sup> On this widely shared moral foundation, scholars, particularly Posner, have attempted to justify even Kaldor–Hicks efficiency on contractual grounds.<sup>61</sup> Should such a justification be sound, this would greatly increase the appeal of the economic analysis of law. By contrast, a legal system that can only be rationalized with reference to Pareto efficiency is subject to the same criticism of hypothetical assumptions and static conditions as Pareto's theory itself.

Hence, the issue arises under what conditions individual actors would agree to suffer adverse consequences if the winners, based on Kaldor–Hicks efficiency, were able to compensate the losers, but had to do so only hypothetically? Consensus theory requires that economic efficiency actually makes everyone better off. Only under these conditions will all individuals involved agree on a particular legal arrangement. To answer the question raised above, two distinct strategies have been discussed. Both strategies differ with respect to the kind of knowledge the parties in the original position possess. Under Posner's approach, the parties in the original position are thought to act under conditions of natural ignorance. In Rawls' model, which was presented in a modified version by John Harsanyi, the parties are assumed to act under conditions of artificial ignorance.

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60 DWORKIN (1980b).

61 POSNER (1983), pp. 88-117.



### 3.3.1. Natural Ignorance in the Original Position

Posner's approach—which is built on Rawls' model—is concerned with actual people that have to consent, in a fictitious original position, to a legal system brought in line with the Kaldor–Hicks efficiency criterion. In this position, the choosers know their identity, i.e., their talents, their character, their social position, and their attitudes toward risks. They plan their lives as far as possible but they cannot foresee the future. They find themselves in a state of “natural” ignorance to the extent that no one knows whether they will actually be fortunate or whether they will be one of the few habitual passersby whose welfare would be increased by, for instance, a strict liability standard rather than by negligence rules for car accidents. In this position, they have to vote on a legal system based on Kaldor–Hicks efficiency.<sup>62</sup>

Whenever legal rules are based on Kaldor–Hicks efficiency, a legal regime is thought to *become* more efficient overall; corresponding efficiency gains may consist of an increase in total economic welfare. For the sake of illustration, assume a simple scenario from antitrust law.<sup>63</sup> A refusal to deal by a market dominant company may, on this view, result in efficiency gains, particularly if the dominant company is able to lower distribution costs below the dealer's average production costs. If such efficiency gains consist of an increase in overall economic welfare, exclusionary effects by the market dominant company on competitors and dealers must be irrelevant from the point of view of Kaldor–Hicks efficiency.<sup>64</sup>

If decision-makers in the original position have to agree on the adoption of such a rule, arguably this rule would not unanimously be consented to by all choosers: there will be quite a few individuals who will lose out under a Kaldor–Hicks efficient legal regime.<sup>65</sup>

Apologists of a consensus-based theoretical justification of Kaldor–Hicks efficiency might be inclined to disagree. It might well be the case that a few members of society will lose *ex post*, as a result of applying Kaldor–Hicks efficiency to a particular legal rule. However, these same individuals will presumably benefit as a result of the application of another rule so that losses and gains will be compensated. What is more, even losers will benefit at a particular point in time (if only indirectly) as a result of the application of such a rule: an increase in overall economic welfare will ultimately make everyone better off. Under a Kaldor–Hicks efficient legal system, *ex ante*, therefore everyone in the original position can expect that they will ultimately benefit. Potential harms will eventually be offset with benefits that result from a change in legal rules.<sup>66</sup>

62 POSNER (1983), pp. 100-101.

63 For the standard account see WILLIAMSON (1968).

64 See, e.g., BORK (1978), p. 307.

65 See KUENZLER (2017b).

66 POSNER (1983), pp. 94-95.

What do these arguments imply? It should be noted, first, that the idea that in the long run losses are always compensated by benefits tends to reduce the economic efficiency calculus to measuring economic welfare in purely monetary terms and thereby screens out factors that can scarcely be captured in this fashion. Most contemporary legal systems for instance acknowledge the ability of an individual to choose to be an entrepreneur rather than to be an employee without their options being restrained by unnecessary barriers to entry or exclusionary practices, i.e., the idea that individual economic activity is not simply a means to an end but also is an end in itself.<sup>67</sup> Taking this observation into account, the maximization of economic efficiency cannot always render everyone better off. It raises the issue of how long it may take for the losers of such a regime to be compensated so that they benefit.<sup>68</sup>

Beyond these methodological issues, the concept of “ex ante compensation” also gives rise to more substantive ethical questions. For instance, a number of people, or groups of people, might from the outset benefit more significantly than others. Kaldor–Hicks efficiency, however, takes a particular income and asset allocation as given. Furthermore, applying Kaldor–Hicks efficiency to substantive legal rules requires lawmakers to evaluate goods that ordinarily are not bought and sold on free markets and for which market prices frequently fail to exist. However, Posner’s asset allocation rule presumes that legal entitlements ought to be sold to the highest bidder. Here, high-income individuals or particularly wealthy citizens will benefit more than others. Simultaneously, and for the same reason, there are numerous people or groups of people who, at present, benefit significantly from “inefficient” legal rules. In an “efficient” society, these people will lose considerably as compared to the status quo, and will have little incentive to consent to a Kaldor–Hicks efficient system. Apologists thus concede that the idea of “ex ante compensation” fails to make everyone better off; instead, the concept of “ex ante compensation” solely states that *in the long run* everyone will benefit.<sup>69</sup>

But even if all members of a society can *expect* to gain in the future, no one individual can be certain that ex post they will *actually* be better off. Although everyone in the original position may have positive expectations, there will always be a few unfortunate ones. The probability of each participant of being a winner is just an expectancy and may, ex post, turn out to be hypothetical. If people in the original position exhibit different risk attitudes, those who are mostly risk averse arguably will oppose a society geared toward Kaldor–Hicks efficiency.<sup>70</sup>

As a result, there will always be at least a few individuals opposing an efficiency-oriented legal system under conditions of natural ignorance. Ronald Dworkin criticized the attempt to justify Kaldor–Hicks efficiency based on consensus-theoretical grounds as follows: if the concept of “ex ante compensation” includes the notion that

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67 See THORELLI (1955); BLAKE and JONES (1965); KUENZLER (2017c), pp. 222-249.

68 KEYNES (1924), p. 80.

69 POSNER (1983), pp. 94-95.

70 POLINSKY (1974).

consent of those losing out can be “bought,” or be “traded in,” then such a system is grounded not on an *actual* but on a *fictitious* consent of the people who are involved in making a decision. A social contract that is based on the consent of many, but not of all, is no social contract. Doing away with the requirement of unanimity—a requirement on which all consensus-theoretical models are based—means doing away with a justification based on consensus-theoretical grounds itself. The argument that the losses of those who are harmed may be offset by the benefits of those who will win is, strictly speaking, a utilitarian one. It does not matter, according to utilitarianism, if only a few consent to such a policy because individuals themselves do not count. Yet consensus theory is based on the view that each individual has their own vote in determining the role and fate of their society precisely because it matters if only a few or everyone agrees.<sup>71</sup>

### 3.3.2. Artificial Ignorance in the Original Position

Unlike Posner, Rawls and Harsanyi assumed that people have to decide under conditions in which they do not know their own identity. The approach taken by Rawls presumes that people decide behind a “veil of ignorance” where they know nothing about their talents, tastes, or abilities, their social class or their status, or even their notion of what is “good” or “bad.”<sup>72</sup> In Harsanyi’s model, the idea that political choices have to be taken under a veil of ignorance is operationalized on the idea that each single individual holds the same probability to take up a particular position.<sup>73</sup> While both approaches exhibit similar features, Rawls and Harsanyi arrive at different conclusions. According to Rawls, in the original position, artificial ignorance results in a system of comprehensive and equal liberties for all and necessitates the principle that social and economic inequalities are only tolerable if they afford the highest possible benefit to the worst-off. Rawls contends that in an original position of equal participants, people will fail to agree on utilitarian conventions because utilitarianism fails to rule out that the welfare of only a few is diminished with a view to increasing the welfare of many.<sup>74</sup> Since no one knows their social position, no one will agree on a criterion under which the possibility exists that they will have to spend their lives as slaves. Participants would, however, agree on the idea that everyone should be afforded the same maximum amount of liberty. This view stands in stark contrast with the approach taken by Harsanyi under which the parties in the original position would choose to agree on a society based on utilitarian principles.<sup>75</sup>

According to Harsanyi, participants under a veil of artificial ignorance would consent to the utility maximization principle because self-interested individuals will always choose the institutional structure that maximizes the *expected utility* of a particular state X. The expected utility that results from such a state is the sum of

71 DWORKIN (1980b).

72 RAWLS (1999), pp. 102-168.

73 HARSANYI (1955).

74 RAWLS (1999), pp. 266-267.

75 HARSANYI (1955), p. 314.

individual utilities multiplied by the probability according to which an individual will take up the respective position. Assuming that for each individual there is the same probability to take up a particular position, in a society with three parties, an individual's probability to take up a particular position amounts to  $1/3$ . If all participants make the same calculation—each participant has to put themselves in everyone else's shoes and determine the utility they experience in the respective position—all individuals will identify an identical sum of total utilities among a particular population.<sup>76</sup>

For example, if the cardinal utility of social arrangement X is 3 for participant A, 5 for participant B, and 10 for participant C, the sum total of all utilities in society X is 18. The total sum of expected utility for society X then is 6 since the probability of being one of the above participants in a society with three members is  $1/3$ . Comparing state X with state Y in which the cardinal utility for A amounts to 6, for B to 2, and for C to 13—and hence, the sum total of all utilities in society Y for all individuals is 21—the expected utility for state Y is 7 in a society with only three members. Under Harsanyi's approach, state Y is therefore preferable to state X.

One issue with Harsanyi's approach is that it is highly unlikely that each individual will have the *same* probability of taking up any one position in a society. Harsanyi's theory implies that the relevant uncertainties of alternative states are equally probable. Moreover, Harsanyi's approach presupposes cardinal utility analysis and interpersonal comparisons of utility. Each participant is supposed to be able to articulate for themselves how much utility which state will produce, and each participant is supposed to be able to put themselves in the position of another individual and to determine their cardinal utility as well. Each participant is supposed to do so and everyone is supposed to arrive at the same conclusion. Only under these conditions can a consensus be reached as to which state actually maximizes expected utility.<sup>77</sup>

An additional objection to Harsanyi's approach concerns the level of *risk aversion* of the parties involved in the original position. Given that in the original position participants remain uninformed about their own risk attitudes, each participant is presumed to have *risk neutral preferences*. Under these conditions, it may be plausible—assuming conditions of artificial ignorance—that participants agree on an institutional structure that maximizes the expected utility of a particular state X. If the parties are *risk averse*, however, a different outcome ensues. Here, the distribution of wealth determines the outcome: if in a particular state X wealth is distributed unequally between A and B but is generally very high and in state Y wealth is distributed evenly between A and B but is generally low, risk-averse parties will tend to prefer Y over X: both A and B need to expect that they will belong to the disad-

76 HARSANYI (1955), p. 314.

77 Rawls explicitly comments on this issue. According to Rawls, statements about probabilities are only possible if there are objective indications of how often certain states will or will not occur, RAWLS (1999), pp. 144-146.

vantaged; however, both A and B would have a higher expected utility in state X.<sup>78</sup> This criticism applies to the economic analysis of law as well because Kaldor–Hicks efficiency cannot ensure that everyone will actually be better off.

At this point, a major difference between Harsanyi's and Rawls' approaches becomes apparent. Rawls' theory is based on the presumption that participants in the original position are highly risk averse.<sup>79</sup> Based on this presumption Rawls arrives at an outcome that differs markedly from Harsanyi's approach. Harsanyi simply observes that decision-making under conditions of artificial ignorance is a "fair game" and that it could thus be assumed that participants would be more risk-seeking than in real life.<sup>80</sup> Apart from this observation, Harsanyi fails to justify *why* participants in the original position are more risk-seeking than Rawls presupposes. Since the parties' risk attitudes are a determining factor in *how a society will be arranged*, without further ado, Harsanyi's simple assumption about the level of risk that individuals are willing to incur can scarcely be entirely convincing.

On top of that, in Harsanyi's theory, an important difference with respect to the relationship between utilitarianism and economic efficiency persists. As intimated above, there is no identity between the utility principle and economic efficiency. Hence, even if we assume that the parties in the original position are risk neutral and agree on the utility principle, it is far from clear whether they will also agree on Kaldor–Hicks efficient legal rules. The utilitarian goal on which the parties agree under such conditions cannot simply be equated with the objective of promoting material wealth in a society. The maximization of economic efficiency will presumably come at the expense of maximizing *other* utilitarian objectives. There are numerous ways in which a utilitarian society may be arranged. The maximization of economic efficiency might be one goal to pursue in such a society but it is unlikely to be the sole one.

### 3.4. Pragmatic Justification of Economic Efficiency

In light of the difficulties just discussed, proponents of the wealth maximization principle, particularly Posner, began to shift their attention toward justifying the economic efficiency rationale on purely pragmatic grounds. The most powerful argument for the wealth maximization principle, according to this view, is not of a moral but of a practical nature. People who live in societies in which markets operate freely are not only wealthier than people living in other societies, Posner argues, but also

78 RAWLS (1999), pp. 143-144.

79 RAWLS (1999), pp. 153-154: "They cannot enter into an agreement that may have consequences they cannot accept. They will avoid those that they can adhere to only with great difficulty. Since the original agreement is final and made in perpetuity, there is no second chance. In view of the serious nature of the possible consequences, the question of the burden of commitment is especially acute. A person is choosing once and for all the standards that are to govern his life prospects. Moreover, when we enter an agreement we must be able to honour it even should the worst possibilities prove to be the case. Otherwise we have not acted in good faith. Thus the parties must weigh with care whether they will be able to stick by their commitment in all circumstances."

80 HARSANYI (1953), p. 435.

have more political rights, more freedom and dignity, and are generally more satisfied with themselves. Wealth maximization, in this account, is the most important basis on which to achieve happiness as a social goal.

This argument forms part of the philosophical tradition of pragmatism, which has defined American legal philosophy to date. Pragmatism had a strong influence on Oliver Wendell Holmes and subsequent American legal realists. The American legal realist movement is difficult to characterize, however, as it failed to accommodate a unified doctrine and failed to form a coherent legal theory itself.<sup>81</sup> Hermann Kantorowicz summarized the movement's claims—which are by no means uncontroversial within the realist camp—succinctly as follows: “The Law is not a body of rules, not an Ought, but a factual reality. It is the real behavior of certain people, especially of the officials of the Law, more especially of the judges who make the Law through their decisions, which, therefore, constitutes the Law.”<sup>82</sup>

Posner's philosophical position, however, does not identify law with actual behavior but with suppositions that describe actual behavior. This view dates back to the so-called prediction-theory of law devised by Holmes. In order to understand what law really is, according to Holmes, we have to take the position of the bad man. The bad man is not interested in legal principles but is interested in how courts will decide. Law is therefore nothing more ambitious than a set of speculations as to what courts will actually do.<sup>83</sup> Understood in this manner, legal rules are “rules of description and prediction.” They can be tested with respect to their informative value by comparing them with subsequent judgments and by determining how they conform or deviate from a particular rule. If there is a high degree of consistency between them, they are considered “real rules,” i.e., rules that embody actual law, as they are literally observed by the courts. If there is a low degree of consistency, they are merely “paper rules,” i.e., rules that are not observed by the courts and are thus only real on paper. The most urgent task of the law, according to legal realists, is the examination of real rules. By contrast, conventional doctrinal questions should receive less attention.

The pragmatic character of Posner's argument rests on the fact that it refrains from justifying wealth maximization as a desirable principle. Legal theory should be less concerned with semantic and metaphysical issues and more with factual—empirical—ones, i.e., it ought to become more pragmatic. Posner refrains from assigning wealth maximization an intrinsic value or from defending wealth as something intrinsically good. Rather, wealth has a value because it enables people to achieve *other* goals. Herein resides Posner's assumption when he observes that countries in which markets operate more or less freely have a high standard of living.<sup>84</sup>

81 MENAND (2001); for an excellent overview see REA-FRAUCHIGER (2005).

82 KANTOROWICZ (1934), p. 1243; see particularly OTT and REA-FRAUCHIGER (2018), pp. 65-67.

83 HOLMES (1897).

84 POSNER (1993).

On close examination, however, Posner's analysis is not free from flaws. Posner for instance contends that the strongest argument in favor of the wealth maximization principle is the fact that in countries in which markets operate more or less freely, people not only enjoy a high standard of living, but also possess more political rights and more freedom and dignity. A high standard of living is primarily thought to result from a free market economy in these countries. Viewed in this light, Posner's argument can be seen as a plea for a society based on economic freedom, which in turn affords individuals the liberty to operate freely (in the economic sphere at least). However, legal rules directed toward economic efficiency represent efficiency not primarily in categories of individual freedom of action or freedom to operate but are addressed mostly toward the collective (i.e., toward achieving overall social or economic efficiency).<sup>85</sup> Such rules have the potential to reduce—not to enhance—an individual's scope of action, and consequently, to make their own autonomous choices. Paradoxically, therefore, Posner's pragmatism might be viewed as a plea *against* the economic analysis of law, at least to the extent that free market mechanisms ought to be stimulated by Kaldor–Hicks-efficient legal rules. Whether or not it is a stated goal of the economic analysis of law to strengthen free market mechanisms as such, the assumptions that this approach is based upon bear a close resemblance to a theory that evaluates individual behavior not based on freedom of choice but on particular outcomes, and thereby presumes that individual actors behave “correctly” only if they work toward achieving these goals.<sup>86</sup>

On the other hand, Posner contends that the welfare and prosperity in the countries he observes are a result of the wealth maximization principle. Posner thereby assumes a minimal state with no social or economic policy regulations. Critics of Posner's account, however, contend that the countries that Posner contemplates—particularly the U.S. and Western Europe—have been thriving precisely *because* their legal systems protect individual rights through equally balanced social and economic policies.<sup>87</sup> These countries, they maintain, have never enforced a policy of radical laissez-faire liberalism as Posner seems to suggest.<sup>88</sup>

#### IV. CONCLUSION

The discussion of the philosophical foundations of the economic efficiency rationale illustrates that there is no compelling position based on which a Kaldor–Hicks efficient legal system might be justified. A purely efficiency-oriented society would most clearly resemble the philosophical position of utilitarianism and would share its deficiencies while eliminating its strengths. Attempts to justify the economic efficiency rationale based on consensus theory are even less convincing. Kaldor–

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85 KUENZLER (2008).

86 KRONMAN (1980).

87 STIGLITZ (2013).

88 KROSZNER and SHILLER (2013).

Hicks efficiency is controversial because there will always be some members of society that will lose in a social system that maximizes wealth. All consensus-theoretical justifications ultimately lead back to utilitarianism and pose new, unresolved problems.

At first sight, therefore, Posner's pragmatic approach, under which economic efficiency should be pursued to accomplish other social goals, seems attractive. But this argument turns out to be a plea for a laissez-faire economics as a key part of free market capitalism. In addition, Posner's hypothesis that wealth maximization brings about more political rights and more freedom and human dignity turns out to be flawed. The minimal state that Posner contemplates has long been abolished—even if its ideas are resuscitated in all parts of the world today—in an effort to mitigate the outgrowths of capitalism and its untenable repercussions on human dignity.<sup>89</sup> *Posner's* arguments therefore can scarcely offer a comprehensive justification of the economic efficiency rationale on which liberal societies are thought to be based.

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89 See WALDRON (2012).



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