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WELFARE ECONOMICS,
MORALITY AND THE LAW

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**WELFARE ECONOMICS,
MORALITY, AND THE LAW**

Steven Shavell*

Abstract

This paper contains the chapters on welfare economics, morality, and the law from a general, forthcoming book, *Foundations of Economic Analysis of Law* (Harvard University Press, 2003). I begin in chapter 26 with a discussion of the normative foundations of economic analysis, namely, the subject of welfare economics. I also describe notions of morality and fairness, which play an important, if dominant, role in much normative discourse about law, and I discuss the connections between welfare economics and morality. A theme of this discussion is that notions of morality have functional aspects, and that, for a complex of reasons, they also take on importance in their own right to individuals.

Then in chapter 27, I consider the observed relationship between law and morality, and comment on what might be thought to be the optimal relationship between law and morality.

In chapter 28, I discuss issues concerning income distributional equity and the law, including the question of whether the distributional effects of legal rules should influence their selection. The answer to this question will be a qualified no, given that society has an income tax system that can serve to redistribute income or to correct problems with distribution that arise due to the effects of legal rules.

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WELFARE ECONOMICS, MORALITY, AND THE LAW

Chapter 26

WELFARE ECONOMICS AND MORALITY

Steve Shavell

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In this chapter, I first discuss the framework of welfare economics that, as sketched in Chapter 1, has been used throughout the book in undertaking normative analysis of law. Then I define and describe the role of notions of morality and, at the end of the chapter, relate these notions to welfare economics.¹ This will enable us, in the succeeding chapter, to discuss the relationship between law and morality and to understand the connections between normative evaluation of legal rules that is based on welfare economics and that relying, at least in part, on ideas of what is right and just.

1. Welfare Economics

1.1 General framework. The term *welfare economics* refers to a general framework for normative analysis, that is, for evaluating different choices that society may make. Under the framework, the social evaluation of a situation consists of two elements: first, determination of the utility of each individual in the situation, and second, amalgamation of individuals' utilities in some way. I will now discuss each of these elements.

1.2 Individual utility. The *utility* of a person is an indicator of his well-being, whatever might constitute that well-being.² Thus, not only do food, shelter, and all the material and hedonistic pleasures and pains affect utility, but so also does the satisfaction, or lack thereof, of a person's aesthetic sensibilities, his altruistic and sympathetic feelings for others, his sense of what constitutes fair treatment for himself and for others (a point that will be of particular importance for us), and so forth. It is important to note too that if there is uncertainty about the future and thus about the utility that individuals will turn

¹I am, of course, well aware that, in dealing with the general subject of morality, which has been intensively and continuously debated for more than two thousand years, no position that a writer advances is likely to be viewed as free from difficulty. A writer can, however, endeavor to be clear, especially about separating the description of moral notions from the prescription of behavior and social decisions on the basis of their agreement or disagreement with moral notions.

²More precisely, a utility indicator or utility function attaches a number to each situation in which a person could find himself, and in such a way that higher numbers are associated with higher well-being. Thus, if situation x is preferred to situation y by a person, the utility associated with x must be higher than that associated with y . For instance, 2 might be the utility of x and 1 that of y , or 20 that of x and 12 that of y . Many different possible utility functions can *represent* the same ordering of possible situations by an individual according to his well-being. However, for concreteness, the reader might sometimes find it convenient to imagine (whether or not it is true) that there is a measurable level of a chemical, or of electrical activity in a region of the brain, that is higher the higher the person's reported well-being is, and that this particular quantity serves as utility.

out to experience, individuals will have a prospective evaluation of their well-being, which can be expressed as their expected utility, that is, as probability-discounted utility.³ As the reader knows, this has the implication that the existence of insurance may benefit individuals because insurance raises their expected utility.

It is apparent, then, that the idea of utility is of encompassing generality; by definition, utility is advanced by anything that raises a person's well-being.

1.3 Amalgamation of utilities through the social welfare function. According to the welfare economic framework, the social evaluation of situations is assumed to be based on individual well-being. In particular, it is presumed that the social evaluation, labeled *social welfare*, depends positively on each and every individual's utility – social welfare is raised when any individual's utility increases -- and does not depend on factors apart from their utilities.⁴

There is a vast multitude of ways of aggregating individual utilities into a measure of social welfare, and no single way is endorsed under welfare economics. One possible measure of social welfare is that of classical utilitarianism, the sum of individuals' utilities. Under other measures, not just the sum but also the distribution of utilities generally matters, and more equal distributions of utility may be superior to less equal distributions.⁵ Under welfare economics, the assumption is not that the evaluation of social states is guided by one particular view about the proper way of amalgamating individuals' utilities (within the general class of ways of so doing), but only that there is some way of doing this.

³A person must have *some* way of evaluating situations involving uncertainty, because the supposition is that he can always state his well-being and state a preference for one situation over another, and some situations involve uncertainty. Thus, the statement in the text that a person has a prospective evaluation is merely an observation about his having well-formed preferences, not a distinct claim about their nature. However, that a person's prospective evaluation of an uncertain situation can be expressed as a probability-discounted sum of utilities -- as an expected utility -- is a distinct claim about preferences, and it can be proved under very weak assumptions (see in particular Savage 1972), but these assumptions need not detain us here.

⁴To express the framework formally, suppose that there are n individuals, and let the utility of the first individual be denoted U_1 , that of the second U_2 , and so forth. Also, let x stand for an exhaustive description of a situation. Then social welfare, $W(x)$, can be written as $W(x) = F(U_1(x), U_2(x), \dots, U_n(x))$. Here, $W(x) > W(x')$ is interpreted to mean that situation x is socially preferred to situation x' . As noted, it is assumed that $W(x)$ increases as each person's utility (U_1, U_2 , etc.) increases. It should be noticed that social welfare, $W(x)$, is influenced by x *only* insofar as x affects the utilities of individuals; it is solely the utilities of individuals that determine social welfare. It should also be observed that the mathematical form of the social welfare function W depends on the utility functions U_i that are chosen to represent the well-being of individuals; if, for instance, for person i we altered the utility function U_i by doubling it to $U_i^*(x) = 2U_i(x)$, then W would be modified such that half of U_i^* would play the role of U_i in W .

⁵For example, suppose that W equals the sum of square roots of utilities, and consider a situation where there are two individuals, and each has the same utility, 100. Then social welfare is 20, namely, $\sqrt{100} + \sqrt{100} = 10 + 10$. This equal distribution of utility is superior to the unequal distribution where one person has utility of 50 and the other 150, in which case social welfare is 19.32 (for $\sqrt{50} + \sqrt{150} = 7.07 + 12.25$), and this distribution is superior to the extreme distribution in which one person has all the utility of 200, in which case social welfare is 14.14 (for $\sqrt{200} = 14.14$).

Comments. (a) *Distribution of income.* Considerations about equity in the distribution of income can be expressed in the measure of social welfare. Notably, the distribution of income affects the distribution of utilities, and this distribution, as just stated above, may influence social welfare in any way. For further discussion of why the distribution of income affects social welfare, see section 1 of chapter 28.

(b) *Exclusion of factors unrelated to individuals' utilities.* The assumption that social welfare does not depend on factors apart from the utilities of individuals can be formally defined in the following way. Suppose that in two different social situations, say x and y , every single individual says, "I am as happy in situation x as I am in situation y ." Then situations x and y must be accorded the same level of social welfare.⁶ (If this x and this y were said to possess different levels of social welfare, it would have to be that something apart from the profile of utilities across the population matters to the evaluation of the social situations.) I will sometimes call this kind of measure of social welfare, the kind that is studied under welfare economics, a *utility-based* measure of social welfare in order to differentiate it from a measure of social welfare that depends on something else as well.⁷

(c) *Exclusion of "objective" notions of well-being as the basis of social welfare.* Consider an objective notion of well-being, for example the notion that any enjoyment derived from the unhappiness of others ought not count as objective utility. Such an objective notion of utility cannot be employed as the basis of social welfare under welfare economics, given the assumption that social welfare is a function solely of individuals' (subjective) utilities.

2. Notions of Morality Described

2.1 Definition of a notion of morality. There are numerous conceptions of what actions are said to be correct, right, fair, just, or moral (I will use these words interchangeably, for convenience). These conceptions are, at least implicitly, ways of evaluating situations; the correct, right, fair, or moral behavior or action is ranked above the incorrect, wrong, unfair, or immoral behavior or action.

Some conceptions of fairness concern equity in the distribution of things. Thus if there is a cake to be divided between two individuals, it might be said that it is generally right for each to be allocated an equal share. Many such ideas of fair distribution may be viewed as methods of evaluation based on the distribution of utilities of individuals. (In the cake example, the idea of fair division of the cake corresponds to a distribution of the cake such that each individual derives the same utility from his portion of the cake.) Any idea of *distributional fairness* can be expressed as a utility-based social welfare function and is thus comprehended under the framework of welfare economics.

Other conceptions of fairness and morality involve factors distinct from, or in addition to, the distribution of utility among individuals. For example, it is said that if a person makes a promise, it is correct for him to keep it; that if one person wrongly injures

⁶Formally, the assumption is as follows. Suppose in two situations x and y , for each individual i , $U_i(x) = U_i(y)$. Then $W(x) = W(y)$. This assumption may easily be verified to be equivalent to the assumption (see note 4) that social welfare $W(x)$ may be expressed in the form $W(x) = F(U_1(x), U_2(x), \dots, U_n(x))$.

⁷In economics, what I am calling a utility-based measure of social welfare is usually called *individualistic*, or sometimes *welfaristic*.

another, fairness requires that he compensate the victim for his losses (the classic notion of corrective justice); or that if a person commits a bad act, it is right that he be punished in proportion to the gravity of the act. On reflection, the reader can verify that these examples of nondistributional moral notions share a basic feature: They are all means of evaluating behavior, and thus social situations, that *do not depend at all, or at least do not depend exclusively, on the utilities of individuals* -- they depend on something else. Promises are supposed to be kept not because, or not only because, this raises the well-being of those who make and benefit from promises (even though that may generally happen); compensation is supposed to be paid for harm wrongly done not because, or not only because, this will insure victims, discourage future harmful behavior, and keep the peace (even though these things will tend to occur); punishment is supposed to be imposed in proportion to the seriousness of the bad acts not because, or not only because, this will lead to reasonable deterrence of bad acts and raise potential victims' utility (even though that may generally happen). Rather, promise-keeping, compensation for wrongs, and correct punishment are important, as moral notions, because they are intrinsically good, or for some underlying reason (such as that they are in accord with a system of natural justice), but in any case not solely, if at all, because of their effects on the well-being of individuals.⁸ I will henceforth focus on these *nondistributional* ideas of fairness and, for expositional ease, will mean by fairness or morality, and the like, a nondistributional conception.⁹

Now to say that a moral notion is a means of evaluating behavior that does not depend exclusively on the utilities of individuals is not enough to define what is usually meant by a moral notion. Consider a rule of behavior such as "Do not wear a hat when butterflies can be seen." This principle of behavior does not depend on individuals' utilities, but the principle is not one that we would call moral. The reason is that what is said to be a moral notion is one that is accompanied by particular types of sentiments on our part, so a second element of a definition of a moral notion that comports with ordinary usage of that term is that a moral notion is associated with these sentiments.¹⁰ I now turn to a description of the sentiments, of the psychological aspects of moral notions.

⁸Formally, a notion of morality that does not depend exclusively on the utilities of individuals is associated with a social welfare function $W(x)$ that is not individualistic, cannot be written in the form $F(U_1(x), U_2(x), \dots, U_n(x))$. That is, given W , there must exist situations x and y such that for each individual i , $U_i(x) = U_i(y)$, yet $W(x)$ does not equal $W(y)$.

⁹Although I am calling notions of fairness that do not depend exclusively on utilities nondistributional, some writers occasionally use the term "distribution" in connection with these notions. For example, corrective justice requires that a wrongdoer compensate his victim, and a writer might say that the compensation paid is a matter of just distribution. I am reserving the term distribution to refer to the allocation of utilities across the population and hope that the reader will not be confused by my usage (which is not idiosyncratic).

¹⁰One observation about moral notions (but this is not part of the definition in the text) is that they apply primarily where the well-being of more than one person is at issue. Promise-keeping, note, involves a promisor and a promisee; punishment involves a wrongdoer and a victim; and so forth. A principle that affects only one individual (such as "go on a diet") would not tend to fit with our use of the term "moral." (There are some exceptions, having to do with ideas of prudence, temperance, and self-control, but the reasons for these principles having the attributes of the other moral principles are, it can be argued, similar to those that will be adduced for the latter, conventional moral principles.)

2.2 Definition continued: psychological attributes associated with notions of morality. One psychological attribute associated with what we tend to call a notion of morality is a feeling of *virtue*, of pleasure of a type, that a person experiences when he obeys a notion; and an opposite psychological attribute is a feeling of *guilt* or remorse, of displeasure, that a person suffers when he disobeys a notion. Thus, when a person keeps a promise, he may feel virtue, and if he breaks a promise, he may feel guilt.

Moreover, it is not just the individual who acts morally or who fails to act morally who may experience an increase or a decrease in utility, as the case may be; it is also *other parties*, including onlookers, who know about the event, who may experience an increase or a decrease in well-being. For example, if we learn that a person has committed a wrong but has been properly punished, we may feel good about that; and if we learn that he has not been punished at all, or has been punished too severely given the gravity of his act, we may feel worse for that reason.

It is also true that onlookers will sometimes derive utility from taking certain actions in the light of behavior that obeys moral notions -- onlookers may praise and otherwise reward good behavior, and obtain utility from so doing (otherwise they wouldn't do it) -- and in the light of actions that violate moral notions -- onlookers may disapprove and otherwise punish bad behavior.¹¹

To summarize, then, I am *defining* a (nondistributional) notion of morality to be a principle for the evaluation of situations that (a) does not depend exclusively on the utilities of individuals, and that (b) is associated with the distinctive psychological attributes leading, as described above, to virtue and guilt, praise and disapproval.¹²

2.3 Tastes for notions of morality and individual utility. It is apparent from what was said in the foregoing section that individuals possess, in connection with a notion of morality, a set of tastes that affect their utility. A person will feel happier, his utility will be higher, if he feels virtue because he kept a promise, or if he learns that punishment of a wrongdoer was correct; and a person will feel worse if he experiences guilt because he broke a promise, or if he learns that punishment of a wrongdoer was harsh. That such sources of utility and disutility are different in their character from conventional springs of utility and disutility (such as satisfying one's hunger and skinning one's knee) is of no moment from the perspective of welfare economics. I will address later the implications of the point that individuals' utility is affected by the satisfaction or failure to satisfy moral notions; here my object is just to make that observation.¹³

2.4 Comment: the existence of tastes for satisfying notions of morality is different from their possible deontological significance. When philosophers discuss moral notions and urge that they be adhered to, they do not generally give as the reason that individuals will be made happy by so doing. Philosophers do not say that individuals should be punished in proportion to the badness of their acts because this will make

¹¹The connection between morality and feelings of virtue and guilt, the moral sentiments, has been developed over the years by, among others, Hutcheson [1725-1755] 1994, Hume [1751] 1998, Smith [1790] 1976, Mill [1861] 1998, and Sidgwick [1907] 1981.

¹²It should be remarked that purely distributional notions of fairness and morality (such as act so as to ensure that the utilities of individuals are equal) are also often associated with guilt and virtue, praise and disapproval.

¹³This point was, to my knowledge, first made by Mill [1861] 1998, 82-84.

victims and onlookers happy in a direct sense. They recommend moral actions on other bases, which may be broadly described as deontological. Indeed, they often are explicit in saying that the justification for a conception of morality is not dependent upon the tastes, the sources of happiness, of individuals in the population; but instead they insist that the justification for the notion derives from independent factors. Otherwise, the answer to the question whether an action is recommended as right by philosophers would depend on the contingency of what the inclinations, the preferences, of the population happen to be.¹⁴ Similarly, when individuals themselves (as opposed to philosophers) explain why a moral notion should be respected, they usually will not say that it is only because that will make them happy; rather, part of their rationale ordinarily is that obeying the notion is correct per se.

2.5 Analysis is descriptive. The reader should bear in mind that what I have said to this point is entirely descriptive; it is what a social scientist would report about notions of morality. I have not stated what role moral notions ought to have in the evaluation of social situations, and in particular in the choice of legal policy. Rather, I have attempted to describe a certain class of evaluative principles, the moral ones, and have pointed out that they are associated with a particular set of tastes (those producing feelings of virtue, guilt, and so forth).

3. Functionality of Notions of Morality

3.1 Notions of morality tend to advance our well-being. It has been long observed, and has been articulated in considerable detail, that the satisfaction of our broadly-held notions of morality tends to advance our well-being. The keeping of promises allows people to plan and leads to cooperative ventures that raise our well-being; punishment according to the gravity of acts deters bad behavior in an effective way and thus raises our well-being; and so forth.¹⁵

3.2 Comment: fostering our well-being is different from the deontological significance of notions of morality. That obeying notions of morality fosters our well-being is not the justification for such notions, according to deontologists. They may admit, and think it good, that obeying promises promotes our welfare, but that is not the warrant for obeying promises in their eyes; they would want promises obeyed even if that did not advance our well-being.¹⁶

3.3 One reason why obeying moral notions tends to advance our well-being: socially undesirable self-interest is curbed. One general reason why obeying moral notions promotes our well-being is that this means that individuals will not behave in self-interested, opportunistic ways when doing so would be socially undesirable. If I adhere to the principle of keeping promises, then I will not break my promise whenever that becomes advantageous to me, whereas if I were to break promises for any personal gain, the value of promises would be diluted and the social benefits associated with promises would diminish. If I follow the principle of punishing in proportion to the gravity of the bad act, I will be less likely to shy away from punishing a person because of fear of retaliation or because of squeamishness, nor will I allow anger to result in

¹⁴See, for example, Kant [1785] 1997, 21-22.

¹⁵See especially Hume [1751] 1998 and Sidgwick [1907] 1981, and see also Mill [1861] 1998.

¹⁶See, for example, Kant [1785] 1997 and Ross 1930.

excessive punishment; were I to act otherwise, the purposes of deterrence might not be well served.

3.4 Another reason why obeying moral notions tends to advance our well being: myopic decisions are prevented. A second way in which following moral notions may advance our well-being is by serving as guides for behavior in situations where it may be difficult to perceive what would maximize our own utility. For example, breaking a promise may be tempting, but keeping promises tends to be in our self-interest in the long run, because doing so means that those with whom we interact now and in the future will come to trust us, and that this trust will benefit us in manifold ways (promises will be made and kept with us, we will be honored and admired, and so forth). Or, it may be that punishing in proportion to the badness of an act will serve our self-interest because we will be dealing with the punished person repeatedly in the future (suppose the punished person is our child). By following a set of relatively simple moral principles, individuals may, to a degree, promote their self-interest without having to think carefully about how they should act to do that.

3.5 Why we tend to obey moral notions: internal and external incentives associated with the psychological attributes of moral notions. For individuals to obey moral notions, they must *want* to do so.¹⁷ Otherwise, they would follow their self-interest, or their apparent, myopic, self-interest.

There are two fundamental reasons why individuals will often desire to obey moral notions, connected with their associated psychological attributes described in section 2.2. One is that individuals have *internal incentives* to do so, namely, they will feel virtuous if they adhere to them, and experience guilt if they do not. Second, individuals have *external incentives* to obey moral notions in that they will be praised by others for that behavior and admonished, scolded, or otherwise punished for immoral behavior.

3.6 Moral notions themselves must also be of particular nature to be functional; in strict logic they could be perverse. The above argument that our well-being is advanced by our adhering to moral notions depends, of course, on the assumption that the particular moral notions to which we subscribe are beneficial ones. If, for instance, there was a moral notion that we should break promises rather than keep them, then adhering to this moral notion would lower our welfare. In that case, if we curbed our self-interest when self-interest would lead us to keep promises, and instead broke promises in order to adhere to the moral notion, the moral notion would tend to reduce our well-being. The question arises, therefore, why, if the class of moral notions that exists tends to advance our well-being, that it is this class, and not a perverse set of moral notions, that we observe. A suggested answer to that question is given below.

4. Origins of Notions of Morality

4.1 Inculcation. It appears that many notions of what is right are taught to us, especially as children, by our parents, teachers, religious figures, and other authoritative individuals, as well as by our peers (notably, in play, when we are children). To a degree, the teaching occurs through example, sometimes it occurs through pronouncement and command, and sometimes it occurs through a species of reasoning referring to the functionality of moral rules. Regarding the latter, it might, for instance, be said to a child

¹⁷This basic point was early stressed by Hume [1751] 1998.

in explaining that promises should be kept: “Think of where the world would be if no one kept his promises.” The process of teaching, and of reinforcing, notions of morality continues beyond childhood as well. The claim that moral notions are to an important degree taught is clear, not only because we know from common experience that teaching does occur, but also from the manifest fact that there is, within a society, substantial homogeneity of moral notions, and that there is among different societies, significant heterogeneity in moral beliefs (compare the norms of the orthodox Muslims of Saudi Arabia to those of present-day Americans, or those of either to the norms of the Aztecs). It is hard to explain why moral notions within a given society are similar, and why those among different societies may display real variation, if moral notions are not to an important extent learned and instilled.

4.2 Evolutionary advantage. Some notions of what is correct may have an evolutionary basis, at least in part.¹⁸ A possible example is the principle that punishment should be imposed, and in proportion to the seriousness of the transgression, for this principle has an evolutionary advantage. In particular, if a person is harmed, say if food is taken from him, this will reduce his chances of survival. Thus, a behavior that reduces the incidence of harm like theft of food will be favored in an evolutionary sense; the genes leading to behavior that prevents theft of food will tend to predominate in the population over the course of time. But the pattern of behavior of punishing, of retaliating, when harm has been done is often against the narrow, momentary self-interest of a person, because after harm is done, it may be too late to undo it, and retaliation may also absorb effort and subject the retaliating person to risk. Thus, a person is likely to retaliate and punish only if he has a *desire* to punish per se. Therefore, we would expect the desire to punish those who have caused harm to be selected as a trait in an evolutionary sense. Further arguments along these lines can be offered for why the desire to punish should be calibrated to the level of harm done. Evidence for the claim that this desire has an evolutionary basis in man is not only theoretical; behavior that suggests that animals are motivated to retaliate in proportion to harm done has been widely observed.¹⁹

Other moral notions that arguably have an evolutionary basis include altruism (certainly for family members; broader forms of altruism may also have an evolutionary basis, or may be a sublimated form of that for relatives).²⁰

Of course, only a subset of our moral notions can have an evolutionary basis, or they can only have a rough basis, for otherwise they could not be malleable, as they are, and could not be learned.

However, it may well be that our *generalized capacity* to learn and to obey moral notions has an evolutionary basis. People who are capable of learning and, of desiring to adhere to, a set of moral beliefs are likely to survive better than those who are not. In the mists of time, such individuals could have learned a set of behaviors that would, given their circumstances, lead them to survive better, cooperate in ways that were good in their

¹⁸On the general theme of this section, see Darwin [1874] 1998, chapters 4, 5, and, for example, Frank 1988, Hirshleifer 1977, Wilson 1980.

¹⁹On the biological origins of retribution, see for example, Daly and Wilson 1988, chapters 10, 11, and Trivers 1971, 49; on the retributive urge in animals, see, for example, Waal 1982, 205-207.

²⁰On altruism, see Trivers 1971 and Wilson 1980.

environment, and the like. Thus, a certain blank-slate character of the capacity to learn moral notions must be valuable, as it allows the notions to develop in a way that is beneficial for persons in a given environment. This capacity to learn a somewhat flexible set of moral notions, in combination with the inherited, genetic predisposition to want to adhere to the learned notions (to feel virtuous if they are obeyed, to feel guilty if not), whatever they are, is highly functional and should have been favored in an evolutionary sense. (If so, then the fact that we appear to have an ability to inculcate moral notions, as just described in section 4.1, is explained.)

4.3 Comments. Several additional remarks about notions of morality are worth making.

(a) *Simple character of moral notions.* From what has been said, it seems to follow that moral notions must be the way that they are observed to be, namely, relatively simple in character. In particular, for moral notions to be taught, especially to children at an early age, they have to be fairly basic in nature. If moral notions were too nuanced, they could not be readily absorbed by children nor by the mass of individuals whose ability to ratiocinate is not high. In addition, if we consider the ways in which moral notions function to raise our welfare, it is apparent that the notions cannot be too complicated. In general, to be practically useful, moral notions have to be capable of being applied quickly, without great deliberation, for many decisions in which they are needed have to be made rapidly. In addition, to serve to curb opportunism, it is advantageous for moral notions to be of a relatively unqualified nature, for otherwise they would be vulnerable to manipulation by individuals who could find reasoning supporting their self-interest. For example, if the moral notion about promise-keeping includes the qualification that promises can be broken for a substantial range of excuses, a person would be able, and perhaps likely, to fashion excuses to validate breaking his promise when that would not be socially desirable.²¹

(b) *Imperfect functional nature of moral notions.* The simplicity of moral notions implies that they will only imperfectly serve to advance social welfare. Because they are simple, they will inevitably fail to induce socially desirable behavior in some circumstances.²² For example, in some situations, it will be desirable for a promise to be broken, because the cost of satisfying it exceeds the benefit it brings about (as I explained at length in chapters 13 and 15), yet this will not agree with the moral notion because the moral notion, being simple, requires that the promise be kept. Another reason, apart from simplicity, that moral notions will not perfectly advance social welfare (whatever that measure may be) is that the notions are learned. This implies that they will have a certain inertia about them, possibly lasting generations, even though they may lose their functionality as circumstances change. Likewise, to the extent that moral notions are inherited due to the evolutionary pressures of the eons, reflecting factors that may no longer exist, they may not be functional, or not perfectly so. The desire to retaliate when we have been wronged may be an example in point, for although there are still benefits

²¹The general view that moral notions must be of a fairly simple character is developed by Austin [1832] 1995, lecture 2, and is emphasized, among others, by Sidgwick [1907] 1981 and Hare 1981.

²²This point is stressed by the authors cited in the previous note, and by Baron 1993, 1994, among many others.

associated with this desire, it may be too strong for our purposes, so that if we could mold it, we would reduce its power.

5. Welfare Economics and Notions of Morality

5.1 In general. In this section, I want to sketch the relationship between welfare economics and notions of morality in the light of what has been said above. The main points are, first, that because of the functionality of notions of morality, they should be inculcated and fostered -- this raises social welfare overall.²³ Second, because individuals have a taste for the satisfaction of the notions of morality (whether inculcated or inherited), there is a direct sense in which the notions have importance in the social welfare calculus; their satisfaction matters apart from the benefits they bring us through effects on our behavior. But third, the notions should not be given importance in social welfare evaluation beyond that associated with their functionality and with our taste for their satisfaction -- no deontological importance should be accorded them -- for doing so would conflict with social welfare and lead to its reduction.

5.2 Functionality of notions of morality implies that society should invest in their inculcation. The arguments given in sections 2 and 3 explaining how notions of morality advance social welfare imply that it is worthwhile for social resources to be devoted to instill and reinforce these notions. Social resources are in fact directed toward teaching moral notions through the efforts of parents and other authority figures, religious institutions, and the like, as described in section 4.1, and possibly through the law as well, as will be discussed in the next chapter. Altogether, the investment of social resources in inculcation of morality is substantial, and may well be justified by the social benefits thereby derived; indeed, greater investment may be warranted. In any case, the point of emphasis here is that, from the perspective of welfare economics, investment in fostering the learning of notions of morality is investment in a valuable form of social capital.

5.3 Notions of morality as tastes affects social welfare. Given that individuals attach importance to notions of morality as tastes, the notions of morality exert a direct effect on social welfare. For example, if I keep a promise and feel virtuous as a result, this feeling, which augments my utility, thereby raises social welfare. Other things being equal, that in turn means that to maximize social welfare, promises should be kept somewhat more often than would be optimal if the measure of social welfare did not reflect this utility that individuals experience from keeping promises. In other words, satisfying notions of morality is itself a component of social welfare, even though it happens to be the case, under the view advanced here, that the reason for the existence of these notions is also to advance social welfare. To put the point differently, the notions of morality have, and must have, importance to individuals in order to induce them to act against their narrow self-interest to advance social welfare. But once this is true, it happens, as a kind of byproduct of their ultimate purpose, that the notions affect social welfare themselves, in their own right.²⁴ (I will sometimes use the term *conventional* social welfare to refer to the measure of social welfare in which tastes for morality do not enter, and will use the term *morally-inclusive* social welfare to refer to the measure of social welfare in which the tastes are reflected.)

²³ Kaplow and Shavell 2002b investigates the optimal inculcation of moral notions, and the optimal use of guilt and virtue to enforce the notions, in a formal model of social welfare maximization.

²⁴As noted above, essentially this view was advanced by Mill [1861] 1998, 82-84 .

5.4 Ascribing independent importance to notions of morality reduces social welfare. The point that satisfying notions of morality influences social welfare by affecting individuals' utilities should be sharply distinguished from the assumption that the notions have independent importance, regardless of the degree to which they raise the utility of individuals. The view that a moral notion, such as the duty of promise-keeping, matters in itself to the evaluation of social welfare is (see section 2.4) the deontological view that is shared, at least in part, by virtually all philosophers. Such views conflict with a fundamental assumption of welfare economics, which is that social welfare depends exclusively on the utilities of individuals.

If a notion of morality is given independent significance in the evaluation of social welfare, it is clear to the intuition that a utility-based measure of social welfare will tend to be reduced, for that measure will be compromised to some extent in order to adhere to the notion of morality. For example, if promise-keeping is granted independent significance, more promises will be kept than would be best if the goal were to keep promises only to advance individuals' utilities, and whatever utility-based measure of social welfare one endorses will likely be lower than it could be.

5.5 Pareto Conflict Theorem. The point just discussed, that according weight to a notion of morality per se tends to lower social welfare, is reflected in the following conclusion: *If independent weight is given to a notion of morality under a measure of social welfare, then in some situations the utility of every single individual will be lowered as a result of advancing that measure of social welfare.*²⁵ That this claim should be true is not surprising, for if the notion of morality has independent weight, this weight will exceed the importance of individuals' utilities between two possible social states if the utility differences between the two social states are sufficiently small. Suppose, for instance, that independent weight is given to promise-keeping, and that all individuals very slightly prefer that promisors be able to break promises when a certain type of difficulty arises.²⁶ Now if the preference of each individual for being able to break promises when this difficulty arises is small enough, the fact that promise-keeping has independent weight implies that social welfare will be promoted by insisting on promise-keeping when the difficulty arises. Thus, all individuals will be made worse off -- their utilities will be reduced -- as a result of the independent weight placed on promise-keeping. Such situations in which all individuals are made worse off can be shown definitely to arise; whatever is the notion of morality, and whatever is the strength and

²⁵The conclusion can be more precisely expressed. Let W be a social welfare function that is not individualistic. Then the assertion is that it is possible to find two social situations x and y such that $U_i(x) > U_i(y)$ for each individual i (that is, x is Pareto preferred to y), yet $W(y) > W(x)$. The proof of this requires only very weak assumptions, essentially that there is some good, such as a consumption good, that all individuals like to possess and that W is continuous in the amounts that individuals have of this good (a much weaker assumption than that W is continuous in many, or all, components of social situations). The conclusion is informally discussed in Kaplow and Shavell 1999 and formally demonstrated in Kaplow and Shavell 2001a.

²⁶The reason that all individuals -- promisors and promisees -- might prefer that promisors be able to break promises if a difficulty arises is that this may raise the value of contracts to both parties. As explained in chapter 15, if the cost of performance in the difficulty exceeds the value of performance, allowing nonperformance will raise the value of the contract to the promisor and to the promisee; the latter will gain because the promisor will be willing to lower the price by more than the decline in value to the promisee due to the increased likelihood of nonperformance.

character of its independent significance, there will *always* exist situations in which maximizing the measure of social welfare reflecting this notion will reduce the utility of *all* individuals. Let me call this conclusion the Pareto conflict theorem, as it states that giving weight to a notion of morality leads to conflict with the Pareto principle -- that if all individuals prefer one situation to a second, the first should be socially preferred to the second.

Several comments should be made about the Pareto conflict result. First, the result implies that any person who endorses the principle that a measure of social welfare should rise whenever the utilities of all individuals rise -- the Pareto principle -- must abandon any view that ascribes independent importance to a notion of morality, which is to say, any deontological view. This is forced upon the person by the requirements of logical consistency. If a theory about the social good conflicts with a principle that one endorses in any situation, the theory must be rejected for that reason.

Second, a response that I have sometimes encountered to the Pareto conflict result is that, in actual fact, one social choice will rarely, if ever, be preferred by all individuals to another, so that, it is said, what would be true were there unanimity of preference can be ignored. This response suffers from a non-sequitur. The premise that, in reality, one social choice will rarely, or never, be preferred by all to another may well hold. But it does not follow from this premise that what would be true in that situation is irrelevant. For if what would happen under a deontological principle would contradict unanimous preferences in a hypothetical situation, such a principle must be abandoned provided that we endorse the Pareto principle (the point just made in the previous paragraph). A hypothetical situation that never arises can be quite relevant, because it can reveal a property of a view that leads us to abandon the view; that the situation never really arises hardly means that we cannot draw implications from what would occur in that situation. If we know that a theory of addition implies that, were we on the planet Pluto, two plus two would equal five, we must abandon that theory even if we know we will never be on Pluto.

Note on the literature. The views presented in this chapter are synthetic, and are based, as indicated in the notes, on sometimes long scholarly traditions. The general conception that moral notions are associated with feelings of virtue, a form of utility, if one obeys them, and are associated with guilt and other emotions creating disutility if one disobeys them, is developed especially by Hume ([1751] 1998), Mill ([1861] 1998), Sidgwick ([1907] 1981), and Smith ([1790] 1976). The fundamental idea that moral notions serve functional purposes is also advanced by these authors, among many others. The observation that moral notions are to a degree inculcated is discussed, for example, by Austin ([1832] 1995) and Mill, and by Hare (1981); and the point that the notions are in some ways produced by evolutionary forces is stressed by Darwin ([1874] 1998) and in much modern day sociobiological literature, for instance, by Trivers (1971) and Wilson (1980). The point that, although moral notions advance social welfare, they do so only imperfectly, due in part to their relative simplicity, is emphasized by Austin and Sidgwick, and see also Baron (1993) and Hare. Regarding the implications of the moral notions for social welfare, the point that it is socially worthwhile to invest in fostering them is consistent with the view of all who see functionality in the notions. The point that moral notions do enjoy importance because individuals derive utility from their

satisfaction, and thus for that reason constitute a part of the social welfare calculus, is made by Mill. The conflict between utility-based social welfare and deontological views of morality has in a general sense been the stuff of debates about utilitarianism and related issues in philosophy; the point that all deontological views necessarily conflict with the Pareto principle, and thus are in deep tension with individual well-being, is demonstrated in Kaplow and Shavell (2001a).

Chapter 27

IMPLICATIONS FOR THE ANALYSIS OF LAW

Having discussed welfare economics and morality in general, let me now examine some of their implications for the legal system. In particular, I here consider the observed relationship between law and morality; the optimal domain and design of the law, taking morality as a regulator of conduct into account; and the nature of normative discourse concerning law and morality.

1. Observed Relationship between Law and Morality

1.1 Rough congruence exists. Most legal systems appear to reflect, in a broad and approximate manner, the moral notions of the societies in which the legal systems apply. In our own country, we see that many acts that the law penalizes are considered wrong, violative of shared ideas of what is moral. Consider murder, rape, robbery, and most crimes; much negligent, tortious behavior; opportunistic breaches of contract; or the creation of nuisances.

Moreover, not only do the acts about which the law is concerned often seem to be wrongful, the legal sanctions that are imposed in response appear to be in rough accord with basic moral remedial principles. In the area of civil law, the general character of the legal remedy is that the wrongdoer pays the victim for harm sustained; notably, tort damages are supposed to indemnify victims for losses and contract damages to make the victim of a breach whole. This central tendency of the civil law is interpretable as that of classical corrective justice, that wrongdoers compensate their victims for harm suffered. In the area of criminal law, penalties rise in some fashion with the gravity of the bad act; roughing someone up in a brawl is penalized less than stalking him and beating him severely, and this less so than his murder. That is to say, criminal punishment tends to bear a proportion to the degree of wrongdoing, which is the underlying principle of retributive justice.

Additional evidence for the claim that the law reflects morality is that legal systems vary over time and among countries in a way that comports with differences in notions of morality. For example, laws concerning the permissibility of types of sexual relations (out of marriage, homosexual) have changed in character over the years in our country, and are much unlike those of conservative Islamic countries, such as Saudi Arabia.

1.2 But substantial differences between law and morality are apparent. Notwithstanding what has just been said, there are important respects in which legal systems do not reflect the notions of morality that a society holds. First, many acts considered to be wrong are not sanctioned by the law. Lying is generally considered immoral, yet it often is not legally punishable (a vast range of false statements that are made in social settings, at the workplace, and in commerce are not actionable). Changing one's plans for modest personal advantage, but to the greater detriment of others, is also often considered wrong but does not give rise to legal sanctions (suppose that I say that I will teach a much needed course, but then bow out because I would slightly prefer to do something else). Also, acting in a grossly negligent way (such as leaving a live wire

exposed where children are playing) is wrong, but will probably not result in a legal action unless somebody actually comes to harm. It is evident, therefore, that there is a substantial domain of behavior that is wrong but is not addressed by our formal legal system.

Second, many acts that are penalized under the law are not considered wrong, or only in a very attenuated way. Where liability is strict, parties face sanctions even if they take all reasonable precautions and thus even if their behavior is not wrongful.²⁷ Another general example is provided by legal rules that most would describe as technical in character, especially those concerned with finance and business -- consider the requirements for registration of securities with the Securities and Exchange Commission and fine points of the doctrines governing the permissibility of mergers under the antitrust laws. These rules cannot easily be linked to our notions of morality. It is possible, though, that because individuals understand such technical rules to have been designed to promote the common good in some way, however indirect and ramified (registration of securities promotes trade in securities, which allows firms to raise capital and individuals to invest, which leads to more economic activity and ultimately to greater welfare), there does exist a refined sense in which individuals feel a duty to obey the technical rules. Nevertheless, I believe the reader will agree that these technical areas of the law do not have a clear moral basis.²⁸

Third, the magnitude and character of legal sanctions sometimes departs significantly from what our moral sense would require. Tort damages are often different from what would seem to be an actor's just deserts. A firm that knowingly acts negligently and in such a way as is likely to cause great harm (including many deaths) but that turns out to cause only modest harm may be required to pay just for that harm, whereas we might well believe that the firm deserves to be punished severely and that responsible individuals within it should bear strong penalties. A party who decides to break a contract because a more advantageous opportunity has arisen may only have to pay modest damages, whereas the moral duty to keep promises might seem to call for more serious legal sanctions. Fines and other criminal penalties also often deviate from retributive principles of proportionality. For example, fines for parking violations may be many multiples of harm done (consider a \$25 fine for parking too long at a metered space), whereas the punishment for murder may be less than the harm done (a few years in jail arguably translates into less than the loss of a life).

1.3 Explanation of the foregoing. The descriptions of the preceding sections make basic sense from the point of view of economic analysis and what has been said in chapter 26 about notions of morality.

²⁷Sometimes, however, it is asserted that our sense of morality would lead to liability for harms arising from engaging in the activities for which strict liability applies (such as transporting wastes across a lake). If this be so, then I would say that the sense of the moral obligation is a weak one, but the reader can judge that issue for himself.

²⁸It is no answer to say that individuals feel a moral obligation to obey all our laws, whether technical or not. This may be true (in which case, note, any rule whatever would be considered to have a moral basis). The question under consideration here is whether legal rules have an independent moral basis -- a basis such that, were they *not* part of our legal system, there would be a moral reason to adhere to them (virtue would be felt if they were obeyed, guilt if not; see section 2 of chapter 26).

Specifically, we would expect to observe substantial, if rough, congruence between law and morality for two reasons. The first is simply that individuals want moral notions to be obeyed; as discussed in section 2 of the last chapter, individuals attach importance to the moral notions themselves and desire that they be satisfied. Because the law is designed by individuals, it is not surprising that the law should be influenced by the value that individuals place on adherence to the moral notions. Thus, for instance, because we believe that promise-keeping is desirable, we wish contract law to promote the keeping of contracts, and because we desire punishment to be in proportion to the seriousness of bad acts, we want criminal sanctions to be fashioned in that way.

The second reason that an observer would expect there to be a degree of resemblance between morality and law is different. If morality and law have the same underlying objective, to promote social welfare, we would predict that these two systems of rules would display similarities. For example, we would expect both morality and our legal system to foster the keeping of promises because that promotes social welfare through inducing cooperative efforts, trade, and production. In other words, it is not just that the law fosters the keeping of contracts because of the moral value people place on promise-keeping, rather, the law has also evolved to foster the keeping of contracts because of the functional value of so doing, and the moral notion of promise-keeping has evolved because of the same functional value.

We would also expect there to be substantial differences between our system of morals and law. The first difference that I mentioned, that there are many immoral acts (like lying) that the law does not sanction, is understandable from the economic perspective. As will be discussed below (see section 2), it is impractically costly for society to attempt to govern a significant domain of undesirable human behavior through the legal system, whereas it is relatively inexpensive and generally sufficient to control much such behavior through our notions of morality alone. Additionally, some immoral behavior is not socially undesirable, so that we would not want to control it through use of the legal system; because our notions of morality are, and must be, relatively simple in character (as was discussed above in section 4 of chapter 26), certain acts that are socially desirable will be seen as immoral, and it would be unwise policy to make them illegal.

The second difference that I noted was that there are many acts that are punished under the law (like improper mergers of businesses) but which are not immoral, or not obviously so. The main explanation for this being the case is that there is much behavior that is worthwhile controlling in order to raise social welfare, and which the law therefore does control. At the same time, some of this behavior is not offensive to our system of morality, because, again, our notions of morality are relatively simple in character. This point will be amplified in section 2 below.

Similarly, the third difference that I noted, concerning deviations between legal punishment and what seems meet from a moral perspective, can be explained by the fact that the law is fairly flexibly designed to promote social welfare, whereas our system of morality has a simple character. For a variety of reasons, sanctions that advance our welfare will not necessarily be set in proportion to the gravity of bad acts. Notably, the social welfare-optimal magnitude of sanctions will reflect the likelihood of their imposition and the costs of their imposition (as was spelled out in chapters 20 and 21),

but these factors are largely independent of the moral quality of acts. This too will be discussed below, in section 3.

1.4 Effect of law on morality. To this point in my consideration of the relationship between law and morality, I have not mentioned the possibility of an effect of the law on our notions of morality and its force,²⁹ but it is probable that this effect exists and I mention here two possible ways in which it may come about.

First, it is plausible that the law influences the moral beliefs that individuals hold. As mentioned in section 4 of chapter 26, our moral views seem to a significant extent to be inculcated and learned. Thus, the law might influence our moral beliefs if it plays a role in instilling and teaching individuals moral values, and one can see that this may be so. For example, a parent or a minister, in trying to impress on a child the lesson that theft is wrong or that discrimination based on skin color is wrong, could mention to the child that the law holds that theft and discrimination are wrong and result in sanctions. This statement about the law could lend authority to the message and make it more likely that the child would learn the lessons and ultimately adopt them as moral values. There is also a possibility that legal rules would exert a similar effect on adults and help to alter their moral beliefs. (But to me this seems a less important factor, given what I perceive to be the small degree to which adults change their fundamental moral beliefs.)

Second, the law can enhance the effectiveness of our moral beliefs by changing our willingness to impose social sanctions on those who have violated notions of morality; this in turn will enhance deterrence of immoral behavior. Consider the inclination of a person who believes that discrimination is wrong to chastise those who engage in it and otherwise impose on them sanctions of a social type. It seems plausible that such a person would be more likely to impose these social sanctions if there exists a law penalizing discrimination. The person might infer from the existence of the law that the view that discrimination is wrong is more widely held in the population than he otherwise believed, and thus that more individuals would join him in condemning this behavior, or would give silent approval, or at least would not resist his condemnation. The existence of the law might also reduce the chance of retaliation against the person contemplating admonishing the discriminator, for the latter could be threatened with legal sanctions. In other words, the rational calculus of a person who holds moral beliefs against a type of behavior, and who contemplates imposing social sanctions on those who engage in the bad behavior, changes in favor of so doing when there is a law against the behavior. In this way, without altering intrinsic moral beliefs, the law can influence their effectiveness because the law increases the likelihood of social sanctions for immoral behavior.

2. Optimal Domain of Law and of Morality

I now consider the question of the optimal domain of morality and of the legal system.³⁰ That is, what is the set of behaviors that it is socially advantageous to control solely through use of our notions of morality, what is the set of behaviors that it is best to

²⁹What has been noted so far is the influence of morality on law -- in that we design the law to reflect our moral tastes -- and an influence on both law and morality of the underlying goal of advancing social welfare.

³⁰This section is based largely on Shavell 2002.

control jointly through morality and law, and what is the set that it is desirable to control through law alone? In examining these issues, I will assume that our notions of morality are as described generally in section 2 of chapter 26, and that the social goal is to employ morality and law so as to maximize social welfare, taking into account the costs and effectiveness of morality and of law as social regulators of conduct.³¹

2.1 General comparison of law and morality as regulators of conduct. As I discussed in section 3 of chapter 26, notions of morality can serve to govern behavior so as to further social welfare by means of internal incentives -- the reward of the feeling of virtue, the penalty of guilt -- and also by means of external incentives -- the reward of praise, the penalty of chastisement. The legal system of course governs behavior through use of external incentives, principally monetary sanctions and imprisonment. Let me now compare morality and law as methods of social control of behavior. After doing so, I will make use of the comparison in an examination of the optimal domains of law and morality.

Establishment of rules. The establishment of legal rules ordinarily is not a very expensive process, requiring only that a law be passed by a legislative body or that a judge make a decision that helps to articulate a rule, and that the rule be properly communicated. However, the establishment of moral rules is evidently very expensive from a social perspective, assuming that this occurs through socialization and inculcation. To instill the moral rules that one should not litter, or lie, or cheat, and the like, requires constant effort over the years of childhood (and reinforcement thereafter). If we regard the duties of parents, schools, and religious institutions as comprised importantly of the teaching of children in the moral dimension, then we can appreciate that society's investment in imbuing moral rules is substantial. Yet one should also note that where moral notions are inborn, or virtually so, establishment of the notions is essentially free from a social perspective.

Specificity and flexibility of rules; degree to which rules reflect socially desirable conduct. Legal rules can be as specific as we please because they are consciously and deliberately fashioned by us. Hence, legal rules can in principle be tailored to promote socially desirable conduct and to discourage undesirable conduct at a highly detailed level. Legal rules are also flexible in the sense that they can be changed essentially at will, as circumstances require. Hence, if what is socially desirable or undesirable changes, so can legal rules change.

By contrast, it seems that moral rules cannot be highly detailed and finely nuanced in character. As discussed in section 4.3 of Chapter 26, these rules need to be inculcated in children, be easy to apply in everyday life, and not be vulnerable to self-interested manipulation. Also, to the degree that moral rules have an evolutionary basis, they will often tend to be simple in character, because very specific rules are generally not ones that have functional value over the long periods of time during which the forces

³¹To amplify, in this section the object is to maximize social welfare where, for convenience, I focus on the effectiveness and the costs of the law and of morality, without taking into explicit account that our notions of morality themselves enter into individual utility and thus into social welfare. This simplification will not affect the qualitative nature of the conclusions reached. For example, were I to take into account how adherence to moral notions itself raises utility and thus is a source of welfare, the conclusion that it is socially desirable sometimes to regulate conduct solely through moral notions, because they are cheapest, would not change (only the boundaries of the domain of behavior over which the sole use of morality would be optimal would change).

of natural selection operate. Additionally, moral rules are not very flexible. Rules that are inculcated are not subject to alteration in the short run, and when the moral rules have a biological basis, they obviously cannot be changed.

The implication of the lack of specificity and flexibility of moral rules relative to legal rules is that moral rules will more often lead to errors in conduct than legal rules. For instance, a person may decide to honor a contract due to the moral obligation to keep the promise it represents, even though breaching the contract would be socially preferable under the circumstances (perhaps the expense of performance greatly outweighs its value to the promisee) and the law would allow breach. Or a person might refrain from reporting the bad behavior of a friend out of a moral duty of fidelity, even though it would be socially desirable for the friend to be reported (perhaps his bad behavior would otherwise continue), and the law might allow or require reporting.

Magnitude of sanctions. Legal rules can be enforced by monetary sanctions and by imprisonment, with no limit in principle save for the wealth of an individual and his remaining lifetime. As such, the potential magnitude of legal sanctions is great.

What is the magnitude of the moral sanctions? I will assume here that the moral sanctions are, over most of their range and for most individuals, weaker, and perhaps much weaker, than high legal sanctions. This is based on the judgment that, at least for the great mass of individuals in modern industrialized nations, the disutility due to losing one's entire wealth or going to jail for life outweighs, and probably by a significant amount, the sting of guilt and of disapproval (or rather, that plus the utility from virtue and praise).³² This is not to deny that for some individuals, the moral sanctions might have greater weight than the legal (a person might fear burning in Hell forever, or find the disapproval of the public to be almost intolerable), nor is it to deny the possibility that in some future world, moral socialization could be such that doing the right thing mattered much more than it now does. But in the type of society in which we find ourselves, where internal moral sanctions appear limited and external ones are diluted by, among other things, the ability of individuals to move, away from those who might reproach them, the assumption that moral sanctions are weaker seems to be the correct one. Another point that should be made is that moral sanctions are unable to prevent bad conduct through incapacitation of individuals, which is something that is accomplished by the legal sanction of imprisonment. Thus, an important tool for reducing bad conduct that is available under the law is absent from the moral arsenal.

Probability of sanctions. The probability of legal sanctions depends on circumstances; the imposition of sanctions for violations is not automatic. For a legal sanction to be imposed, the violation of law needs to be observed by someone, and then it has to be reported. Even where it is observed by the victim and he can bring suit, such as might be the case with a tortious harm and would usually be the case with a breach of contract, the victim might not find legal action worthwhile given its cost. Also, for many violations for which enforcement is public, the likelihood of sanctions is notoriously low.

³²The true incentive to act in a moral way is the difference between one's position when one acts morally and when one does not; it is thus the *sum* of the utility of the reward for acting morally -- the utility from virtue and praise -- and the disutility from doing otherwise -- the disutility from guilt and disapprobation.

In contrast, the probability of imposition of the internal moral sanctions is one hundred percent, as previously noted (self-deception aside). A person who believes that it is immoral to cheat on his taxes will definitely feel guilty for so doing, and will definitely feel virtuous for paying the proper amount, because he will know whether he honestly paid his taxes.

The probability of imposition of the external moral sanctions, of disapprobation and praise, is a different matter, and may or may not be higher than that of imposition of legal sanctions, depending on the context. For instance, the likelihood that a person would be seen cutting into a line and would suffer the external moral sanction of sour looks is presumably high (for others in the line would notice), but the likelihood of being found out and of experiencing disapproval for cheating on ones taxes might be lower than that of being caught in a tax audit, for tax cheaters are unlikely to be caught by their fellow citizens.

Availability of information for the application of rules. In the application of legal rules, certain information is needed. But information can be difficult to acquire or verify, such as that concerning whether a person committed a crime and, if so, what exactly the circumstances were. The difficulty associated with substantiation of information has two disadvantageous implications. One is that errors may be made, such as when a person is found guilty of murder when he really acted in self-defense, or when he is found to have acted in self-defense when he in truth did not. The other is that legal rules are sometimes designed in a less refined manner than would be desirable if more information were available. For example, bartenders might be held strictly liable for serving liquor to minors because information about bartenders' true opportunities to determine the age of customers is generally hard to obtain.

These disadvantages due to difficulties in obtaining information do not apply in regard to the enforcement of moral rules with internal sanctions, because a person will naturally know what he did and why. If a person kills someone, he will know whether he acted in self-defense; if he serves liquor to a customer, he will know whether he suspected that the customer was underage. The virtually perfect quality of the information that a person has about himself means that the internal moral sanctions will not be erroneously applied and that the moral rules need not exclude any potentially relevant information.³³

The conclusion is somewhat different, however, with respect to enforcement of moral rules with external sanctions. Here there may be informational difficulties, for the observer of conduct may not have all the relevant information or may make errors. Nevertheless, these problems are often less serious than those faced by the legal system. When a person's conduct is observed by another person, such as when one person catches another in a lie, the observing party who chides or reprimands the wrongdoer does not have to establish what he knows to the satisfaction of a tribunal. Additionally, there is a

³³The point of this paragraph may be compared to the point made above that moral rules may lead to socially worse outcomes than legal rules because of the limited complexity of moral rules. Here, the point is that moral rules may lead to socially superior outcomes than legal rules do, because of the greater information that may be available for the application of the moral rules.

peculiar self-correcting mechanism at work in respect to the imposition of external sanctions: If a person is mistaken in his criticism of another, the reproof may be dulled in its impact, for it seems to be a psychological fact that disapproval will not register as much if it is not deserved.

A further point about external moral sanctions, but working in favor of legal sanctions, is that parties who observe the conduct of others may sometimes not possess certain relevant information that could be acquired in a legal setting. For instance, if one person observes that another breaks a promise to him and is given an excuse as the rationale, the victim of the broken promise might not be able to determine whether the excuse is the truth. However, in a legal setting, an excuse offered for breaking a contract could be investigated; witnesses could be forced to come forward and to testify under oath.

Costs of enforcement. The costs of enforcement of legal rules have to do with the expenses of identifying violators and of adjudication, which can be substantial, especially when public enforcement agents are involved. By contrast, the costs of enforcement of moral rules are non-existent in regard to internal sanctions. In regard to external sanctions, costs of enforcement are probably lower on average than those of legal rules, even though there might be some adjudication in the form of gossip and discussion of the propriety of acts.

Costs of imposition of sanctions. Legal rules involve sanctioning costs, and these depend on whether the sanctions are monetary or are terms of imprisonment. As has been discussed in chapters 20 and 21, monetary sanctions are sometimes said to be socially free, or at least much less expensive than imprisonment.

Regarding moral sanctions, consider first guilt. Because guilt does not involve administrative expense to effect, it appears to be a socially cheaper form of sanction than imprisonment. Disapproval is much like guilt as a sanction, except that the consequences of its use for those who express it need to be incorporated into the social calculus, and what should be assumed about this matter is not entirely obvious. Virtue and praise obviously differ from guilt and disapproval in that they are sanctions that create utility, rather than lower it.³⁴

The conclusions about the costs of imposing sanctions may be expressed as follows: The legal sanction of imprisonment appears to be the most costly to impose, monetary sanctions may or may not be more costly to impose than guilt and disapprobation depending on administrative expense, and virtue and praise actually increase social welfare when employed as incentives.

³⁴For an economically oriented analysis of the moral sanctions of guilt and virtue, taking into account that guilt is costly and that virtue creates utility, see Kaplow and Shavell 2001b.

Amoral individuals. To this point, we have been considering general factors bearing on legal versus moral rules, but a particular factor of potential significance bears mention. Namely, there may be individuals in the population for whom moral incentives are not very important. Indeed, this group may not be small in size, especially in societies, like that of the present-day United States, where families and other social institutions that provide stable environments for the socialization of children are often weak. The existence of a relatively amoral subgroup of the population implies that, for them, moral sanctions will fail to prevent much immoral behavior. Members of this subgroup will, by assumption, not be affected by the internal moral incentives of virtue and guilt, and will probably also not care as much as others about the external incentives of disapproval and praise. Moreover, these individuals will be unlikely themselves to impose the external moral sanctions called for by the misconduct of others, exacerbating the breakdown of the power of moral incentives. The presence of amoral individuals is thus a factor that favors legal rules over moral rules.

Firms (and other organizations). Another special factor worthy of note is that the power of moral incentives may be diluted within firms (and other organizations). Consider first the internal moral incentives, and let me note initially the familiar point that, because a firm is not in fact a person, but rather a collective comprised of different individuals, we cannot speak in a literal sense of internal moral incentives in respect to a firm. However, individuals within a firm can feel guilt or virtue in regard to their own behavior. A reason for thinking that the internal moral incentives may be less effective in the setting of the firm than outside that setting is that decisions within firms are often made jointly by groups, or influenced by orders from above, or acted upon and influenced by subsequent decisions made below; this serves to attenuate the sense of personal responsibility for one's acts. Another factor is that firms often attempt to establish their own norms of loyalty (consider the corporate ethos at companies like IBM), which may tend to offset the usual moral incentives when the latter come into conflict with the objectives of the firm.

Second, the external moral incentives have unclear force in relation to employees of firms. One reason is that, as just remarked, responsibility within a firm is often diffused, so that there often will not be specific individuals within firms whom outsiders will be able to identify and punish for wrongful behavior. Another reason is that a firm may have an incentive to conceal the identity of responsible individuals within it, just so they can escape external social sanctions. However, outsiders may impose external sanctions on a firm even though they have not identified a responsible individual within it. For example, they might refuse to make purchases from a firm that acted in a grossly negligent manner.

Summary. The discussion of this section shows that law and morality each has advantages over the other in certain respects, which may be summarized (I omit qualifications) as follows. Law may enjoy advantages over morality due to the ease with which legal rules can be established, their flexible character, and the plausibly greater magnitude of legal sanctions over moral sanctions. Also, the presence of amoral individuals is a factor favoring reliance on law, as is the presence of firms, for whom moral forces are likely to be relatively weak. However, morality may possess advantages over law because moral sanctions are often applied with higher likelihood than legal ones (notably, internal moral sanctions apply with certainty), may reflect superior and more

accurate information about conduct, and may involve lower costs of enforcement and imposition.

2.2 Domain in which morality alone is optimal. It will be best to control behavior solely through use of morality when three conditions hold: first, that morality functions reasonably well by itself; second, that morality is not worthwhile supplementing with law, given the social benefits that would flow from that and the added costs; third, that law alone is not as desirable to employ as morality alone.

These conditions will tend to apply when two things are true: The expected private gain from undesirable conduct is not too great, and the expected harm due to such conduct is also not too great. For if the expected private gain from bad conduct is not too great, then the moral sanctions, even though not as strong as legal sanctions, will very often be sufficient to discourage the conduct. And if the expected harm from bad conduct is not too great, then on those occasions when moral sanctions fail to prevent the conduct, the social effects will not be so serious, and thus would not warrant the added expense of the legal system as a supplement to morality. However, the question remains whether it might be more desirable to employ law alone than morality alone. The points just made imply that the social value of law over morality will not be great, so that use of morality alone will be superior to use of law alone when the added expense of the law exceeds its modest marginal social value.

Let us now examine the domain in which behavior is in fact controlled primarily by morality. This area of behavior is, as indicated above, comprised of a great multitude of acts that we undertake in everyday life. Consider the keeping of promises about social engagements, acting so as to refrain from creating minor nuisances, or lending a helping hand when that is not difficult to do. I suggest that this domain of behavior where mainly morality applies is broadly consistent with the theory advanced above. In particular, the expected private gains from bad conduct are in fact typically small or modest. If a person breaks a lunch date, cuts into a line, or fails to keep quiet in a movie theatre, the benefits that he obtains are not usually of large magnitude. This being so, the moral sanctions will often be enough to deter bad conduct; the automatic functioning of the internal moral sanction of guilt, combined with the external sanctions, will frequently be sufficient to dissuade individuals from acting incorrectly. Further, when that is not so and individuals do engage in bad conduct, the harms they cause appear on average to be minor. Again, if a person breaks a lunch date, cuts into a line, or talks in a movie theatre, the social detriment will usually not be significant. Hence, the claim is that it would not be socially worthwhile to append the legal system to the moral system in order to help prevent this residuum of bad acts from occurring. That is, it would not be advantageous to subsidize civil suit to bring about legal actions for such harms as broken lunch dates, or to employ public enforcement authorities to hand out tickets for cutting in line or talking in movie theatres, because the cost of doing so would outweigh the benefit from the not-too-great additional harms that would be prevented.

Moreover, the disadvantage of appending the legal system to the moral one in the domain under discussion is not limited to the direct costs of use of the legal system; it is also likely that many mistakes would be made under the legal system relative to that under the moral one. When an individual breaks a lunch date or cuts into a line, he will know about this and, as noted above, will not make errors in judging the correctness of his own behavior. Also, the assessments of those around him will tend to be reasonably accurate,

at least by comparison to those that would be made under the legal system. The legal system could not hope to sort out, in the way we do ourselves, broken lunch dates due to valid excuses (suppose that a truly good friend appeared unannounced from out of town) from those that are not. The mistakes that would inevitably be made under the legal system, especially punishment that is not merited, constitute a separate cost that reinforces the argument against use of the law in the domain of everyday conduct.

It remains to consider whether it might be desirable to employ the law alone instead of morality alone in the area of behavior in question. In order to assess how law alone would function, we must imagine a world in which people are unlike people as we know them -- we must envision individuals who are devoid of compunctions about breaking promises, lying, and the like, who essentially do not care about each other, who are sociopathic. And we must ask in this notional world how well law would control the behavior and about the expense of control. A strong surmise is that it would be enormously expensive to control the behavior at issue because of its variousness and extent, that society might be bankrupted by a serious attempt to do so, and, as mentioned in the previous paragraph, that many mistakes would be made. The conclusion is that use of law alone would be clearly inferior to use of morality alone in the domain where morality is observed to be relied upon.

2.3 Domain in which morality and law are optimal. It will be best to use law to supplement morality where the cost of so doing is justified by the extra social benefit. This will tend to be true when two conditions hold: The expected private gains from undesirable conduct are often large, and the expected harms due to such conduct are also often large. For if the expected gains from bad conduct are great, then the moral sanctions may not be enough to prevent it. And if the expected harms from bad conduct are substantial, then failure to prevent bad conduct will be socially serious, and thus make worthwhile the additional expense of the legal system as a supplement to morality.

Let us now consider the range of behavior that is regulated both by morality and by law. This area covers most acts that are criminal; murder, rape, robbery, fraud, and like acts are not only crimes but also are generally said to be immoral. Additionally, many torts, including most acts of negligence, many breaches of contract, and many violations of regulations are not only legally sanctionable but also are considered not to be moral.

It appears that this domain of behavior is characterized by the condition that the private gains from bad conduct are often large. The utility obtained by those who commit criminal acts tends to be significant; the murderer, the rapist, and the thief generally have strong motivations to act. Also, the private benefits obtained by those who commit many torts or breaches of contract are substantial, especially because large amounts of money are frequently at stake. Hence, the internal moral sanctions alone will often not be enough to prevent the bad conduct.

Another reason for failure of moral incentives to control conduct in the domain is that the external moral incentives are often unlikely to apply, because the bad actor will not be noticed or, if noticed, will not be reprimanded. This is obviously so of many criminal acts. Similarly, behavior that can give rise to torts often goes unspotted, or at least does not result in disapproval. For example, consider improper driving behavior, such as speeding or going through a red light. If a driver does these things, he often won't be noticed, and if he is, how is it that other drivers are going to have the opportunity to

scold him? The external sanction of disapprobation is unlikely to be brought to bear in many other situations in which accidents might occur, and in which tort law and safety regulation are in fact brought to bear. This point should not be overstated, however. There are important situations, such as breaches of contract, in which problematic conduct will be noticed and there will be ample opportunity for observers to express their disapproval of it.

It also seems true that the condition concerning the harm from bad conduct applies in the domain in question. The social consequences of failure to control crimes and torts, which often result in injury and death, as well as breaches of contract and many of the other acts to which our legal system applies, are manifestly great (especially in comparison to the consequences of broken lunch dates, cutting in line, and other quotidian misbehavior). Hence, the benefits from preventing these harms through use of the law, when they are not prevented by morality, are significant, and these benefits outweigh the costs of employing the legal system.

Additionally, the problem of amoral individuals is of obvious relevance to the issue at hand. Because the magnitude of harm from the undesirable conduct that we are considering is great, the existence of amoral subgroups is of special significance. Even if small, such subgroups, if unchecked, can wreak great social harm, especially through repeated crimes, but also through extremely negligent behavior, failure to obey contracts, and other bad acts.

The presence of firms further supports the thesis that law is needed as a supplement to morality in the realm of behavior under discussion. As suggested earlier, the force of moral sanctions, both internal and external, is diluted in respect to the behavior of firms. Firms, though, are often in a position to do large harm by virtue of their size and importance in modern economies; they mediate most production and exchange and can cause much physical and economic injury from misconduct. Hence, if society attempted to control the behavior of firms only by resort to moral sanctions, substantial harm would result. Legal rules, however, do alter the behavior of firms for the good, either directly, by fiat, or by threat of monetary sanctions.

Thus, altogether, my conclusion is that for most of the acts that society has chosen to control through the law and through morality, the use of moral incentives alone would not function well due to some combination of the following factors: substantial private benefits from committing bad acts, inadequacy of internal and external moral sanctions to counter the private benefits, the presence of amoral subgroups, and the activity of firms. The imperfect performance of our moral system as a regulator of conduct, together with very high social costs of failure to control conduct, warrants the use of our costly legal system.

A different reason why law may be socially useful in controlling conduct where morality also applies is, in a sense, the opposite of what has been discussed so far in this section. Namely, it may happen that a notion of morality is socially counterproductive, and legal rules are needed to channel behavior in a different, and socially desirable, direction (rather than that legal rules are needed to steer behavior in the direction that morality already points).³⁵ For example, I mentioned the possibility that a person might refrain from reporting a friend's bad conduct because of a feeling of loyalty, even though

³⁵This is a theme of E. Posner 1996.

reporting the conduct might be socially desirable, or that a person might not want to breach a contract, even though breaching might be socially desirable given the high cost of performance. If so, legal intervention, requiring the reporting of the friend or permitting breach, might be socially desirable. Although these situations in which law may be needed to offset the effect of morality are not typical, neither are they rare, and this should not be considered surprising. As stressed above, moral notions cannot be too complex for various reasons, and thus we would predict that they would come into conflict with socially desirable behavior in some circumstances.

Having considered why it is beneficial to supplement morality with law to control the behavior under discussion, let me address the question of why would it not make sense for society to rely solely on the law to control the behavior -- that is, why it is beneficial to supplement law with morality. For example, why should society not rely solely on criminal law to combat murder? A primary answer must be that law will only imperfectly deter murder, and given the seriousness of that act, society will find it advantageous to employ morality also as an instrument of control. There will be many occasions in which a person would be unlikely to be caught for a murder that would advantage him, but if he thinks murder is a moral evil, he might not even contemplate that act, much less commit it. As a general matter, legal rules do not always apply, and even when they do apply with high likelihood, the sanctions may not be strong enough to deter bad behavior. For this reason, and because the harm from the acts in question tends to be large, society will find it worthwhile to buttress legal rules with moral ones, presuming that the cost of so doing is not too large. (And as I will explain below, the cost of these supporting moral rules may be quite low, possibly zero.)

A second rationale for supplementing law with morality is that legal rules may not reflect certain information that is relevant to achieving socially desirable outcomes, whereas moral rules can reflect such information. For example, the law might award low damages for breach of a contract to photograph an important event, since proving its significance to a court might be difficult. However, the photographer might well realize from personal observation that the event is important, and thus if he feels it is his moral duty to keep promises, he will not breach the contract even though he can do so by law and it may be in his self-interest to do so. This is an example of what was discussed in part in section 2.1, that the information that is available to apply moral rules may be superior to that available to apply legal rules. On reflection, there are many cases in which the law does not take into account factors of relevance, due to difficulty of proof, but the involved parties know of these factors and, spurred by moral considerations, might act in a socially desirable way even though the law would not lead them to do this.

A third consideration is that moral rules may often be inexpensive supplements to legal ones. Let us consider the moral rule against murder as an example. The act of murder falls into a general category of conduct -- that of intentionally harming others -- that it is socially desirable to treat as wrongful. It is desirable to treat this general category of conduct as immoral because the acts in it tend to be socially undesirable and because much of the category is not controlled by law: There are innumerable ways in which individuals may intentionally harm each other in everyday life that we do not want to occur and that the broad moral rule at issue discourages, but which the law does not affect. Moreover, a refined moral rule under which murder would not be viewed as immoral would probably be unnatural and psychologically jarring, because of the evident

underlying similarity between murder and many of the other acts that involve intentional harm and that are classified as immoral. Additionally, for the various reasons given earlier moral rules cannot be too nuanced and thus could not accommodate such distinctions. In sum, then, the argument concerning the moral rule against murder is this: Given that society finds it advantageous to have a *general* moral rule against intentionally harming individuals, society enjoys, as a byproduct, the application of the general moral rule to murder, as a supplement to criminal law. Similar arguments can be given for many other acts that are in the domain controlled by both law and morality; these acts fit under the head of some general moral rule that society has good reason to establish.

2.4 Domain in which law alone is optimal. It will be best to control behavior solely through use of law when, among other things, morality does not function well alone and law is needed to control behavior. These two conditions will tend to hold when the expected private gains from undesirable conduct are large and the expected harms due to such conduct are also large. For, as has been discussed above, if the expected private gains from bad conduct are large, then the moral sanctions may not be enough to prevent it; and if the expected harms from bad conduct are substantial, then failure to prevent bad conduct will be socially serious, and thus will justify use of the legal system. A third condition that must hold in order for law alone to be optimal is that law is not worth supplementing with moral rules in view of the cost of so doing.

Before considering the relevance of the foregoing to what is observed, let us ask whether there does exist a domain of behavior in which primarily the law applies, in which morality is only weakly or not at all relevant. It was suggested earlier that many of our technical, often fairly detailed, legal rules have this character, such as a rule requiring that a company have at least a stipulated amount of capital to be allowed to sell securities on an equity market. Another example is a rule mandating the use of a particular accounting convention for valuation of inventories (such as last-in-first-out), or a rule proscribing the planting of an apparently innocuous species of tree in an area. What I am claiming is that it would not strike a person as intrinsically immoral -- as immoral in the absence of a law bearing on the matter -- for a company to sell securities when the company possesses less than the stipulated amount of capital, or for a company to use some other accounting practice for valuing inventories, or for a person to plant the species of tree that is mentioned as prohibited. (Although I do not think that people would view such conduct as intrinsically immoral, that is, as immoral were the conduct legal, individuals would be likely to think this conduct immoral just because it is illegal; there is a general moral duty to do what the law asks. I am, however, excluding this particular moral rule from consideration, for otherwise the question that I think it natural to examine here would be mooted.)

Now let us consider whether the two conditions about gains and harm that I mentioned above hold in the domain at issue. Regarding the first, it is fairly clear that the private gains from undesirable conduct are frequently large enough that legal sanctions, as opposed to merely moral sanctions, are needed to obtain a tolerably good level of compliance with rules. Consider the often substantial gains that can be obtained from improper sale of securities, or from a self-serving choice of method for the valuation of inventories. Moreover, the actors whose conduct needs to be controlled are often firms, which, as noted, dilutes the force of moral sanctions. It seems doubtful on the whole that many of the regulations now enforced through use of the legal system, many times

through public enforcement effort and the threat of criminal sanctions, could be reasonably well enforced by moral sanctions alone.

The second condition that we want to verify is that the harm that would follow from failure to comply with the rules in question would be substantial. This becomes evident from reflection on the purposes of the rules. Consider the minimum capital requirements for the registration of securities. If these are not met, there may ultimately be non-trivial consequences for the functioning of securities markets (for instance, erosion of investor confidence in the quality of securities). As the securities markets contribute greatly to the health and productivity of our economy, it is very valuable for the rules about the registration of securities to be satisfied. Likewise, if there are not uniform accounting rules for the valuation of inventories, investors and lenders will have to spend more time than they now do unraveling the meaning of financial statements, which would impede the functioning of our capital and credit markets. The general claim, in other words, is that our somewhat detailed technical rules are often like these examples; upon examination, one finds that they have real and significant rationales, and therefore that substantial social harm will result if they are violated. Thus, I have suggested that, when one considers the two conditions in the domain in question, it does indeed seem that legal rules are needed as a mechanism of control.

The question remains, however, why morality is not desirable to employ as a supplement to the law in the domain we are discussing. For morality to function in this way, one approach that could be taken would be to teach as individual moral rules the various legal rules at issue. Thus, we could teach children that it would be immoral for a firm to sell securities unless the firm's capital is higher than X, that it is immoral to plant species Y of tree, and so forth. But it is manifestly impractical to accomplish this task, and it would be nonsensical to think that we could, or would, try to instill rules like this in our children. The sheer number and the changing nature of the rules would bar our teaching them to children, and in any case the specific nature of the rules would often render them difficult for children to absorb (what does a child know about the sale of securities, particular species of trees, and so forth?).

Another approach that society could employ to use morality to reinforce the law in the domain in question is to instill in children some overarching moral principle that, in its application by adults, would yield the many particular rules under consideration as subsidiary, implied moral rules. Arguably, the only overarching principle that could rationalize all these diverse rules is that of a general utilitarianism, of social welfare maximization. It does seem true that a form of this principle not only could be, but in fact is, imbued in us: the general obligation to do good, to do whatever it is that helps society. However, the force of this moral rule is attenuated when it is not clear how it applies, and this tends to be the case with regard to the legal rules under consideration; identifying them as being in the social interest involves a fairly complicated train of thinking. Recall the argument given above for why a firm ought to have at least X in assets before it can sell securities; the logic behind the social desirability of this rule is not transparent (it is far more complex than that behind the typical moral rule, such as that one ought not hit someone, or one ought not lie). In other words, I am suggesting that the only overarching moral rule that could resolve itself into the body of technical legal rules in question is the general moral rule to maximize social welfare, and while we do have this general rule instilled in us as a moral rule, it is rendered weak in the domain in question because it is

too difficult to apply, owing to our inability easily to recognize which of the technical rules are or are not in the social interest.³⁶ Thus, we must rely primarily on the law to induce compliance with such rules.

3. Optimal Design of the Law Taking Morality into Account

Having discussed in general terms the optimal domains of law and of morality, I now want to focus on the area of behavior in which both law and morality apply, and to examine the more specific question of how the law should be designed in the light of morality. For instance, how should tort liability be determined given our ideas of wrongful behavior? Although it is this type of question that is the major issue below, I will also briefly consider, at the end (in section 3.5), the question of how law should be designed if it can influence morality.

3.1 In general. In fashioning legal rules to maximize social welfare, the moral system must be taken into direct account to the extent that individuals have a taste for satisfaction of moral notions. That is, legal rules should be designed to maximize morally-inclusive social welfare. However, as I emphasized in section 5 of chapter 26, moral notions should not be given weight per se, independently of the importance individuals place on them as tastes, for that would lower social welfare. To appreciate the significance of these distinctions, it will be helpful to reconsider briefly several of the major subject areas of law examined in this book and to comment on how taking morality into account would, or would not, affect the previous analysis of them, which was based on conventional, not morally-inclusive, social welfare.

3.2 Torts. The main notion of morality that bears on tort law appears to be that of classical corrective justice -- the wrongdoer must make his victim whole -- and it will serve my purposes to focus on this principle even though there are others, mainly subsidiary, that could be considered as well. The most natural interpretation of corrective justice is that the negligence rule should govern liability, for negligence connotes wrongful behavior. Conversely, strict liability would seem to be inconsistent with corrective justice, for it results in liability independently of whether a person has acted wrongly.³⁷

How moral notions ought to be taken into account. Under the assumption just made about corrective justice, the negligence rule will be the optimal legal rule more often than I found it to be best under conventional measures of social welfare. In particular, where I suggested that the negligence rule was inferior to strict liability, due to excessive activity levels under the negligence rule (see chapter 8), the negligence rule might now be optimal because of the taste individuals have for it. Or individuals' taste for

³⁶In fact, society is able to harness the general moral rule to do social good by making an act illegal. For then the rule is marked as likely to advance the social good. For example, an individual need not understand *why* selling securities without having capital of X is against the social interest; the fact that that is illegal conveys this to the individual.

³⁷There are other interpretations of corrective justice that might be advanced, under which, although negligence is usually the best rule, strict liability is said to be appropriate when activities impose unusual risks on others. However, the qualitative nature of the arguments I will make would not be altered were I to consider such an interpretation of corrective justice.

the negligence rule might imply that that rule is best where, under conventional social welfare analysis, no liability would be desirable owing to the administrative costs of the liability system or its small effect on incentives.

Individuals' taste for corrective justice might also affect the conclusions about the magnitude of damages, for corrective justice implies that damages should make the victim whole, but this was not always the result found earlier. For example, I said that damages received should usually be limited to monetary losses, and not compensate for nonmonetary losses (essentially because receipt of more money by the victim is not as beneficial as receipt of fine revenue by the state).³⁸ In such situations, the factor of corrective justice would lead to the desirability of raising damages paid to victims. There were other cases that I investigated in which the influence of corrective justice on optimal damages would be similar.³⁹

The degree to which the conclusions reached under conventional social welfare maximization should be altered depends on the answer to the empirical question of the strength of individuals' tastes for corrective justice. In making a conjecture about that taste, the reader should bear in mind the point that in order to determine the importance of it, a person must be able to separate the functional value of corrective justice in reducing harm and in compensating victims from its other value. The mental experiment that this requires is not easy. One would have to answer questions such as the following: "Suppose that, under the negligence rule, society experiences the same number of accidents as it would under a no-fault system and that compensation of victims is also the same. How much would you be willing to pay each year to have the negligence rule govern, even though it has no effect on outcomes?" It is not obvious to me how most people would answer such questions.

Another problem in assessing the importance of corrective justice in the tort context concerns insurance. One needs to know how a person's taste for satisfaction of corrective justice is influenced by the fact that judgments are usually paid by liability insurers rather than by wrongdoers, and by the fact that victims may well be compensated by their own first-party insurers, or that they would be in the absence of receipt of damage payments.

How moral notions are actually taken into account. What the analyst should not do is ascribe importance to moral notions apart from their importance as tastes. This, however, seems widely to be done. It is typical for commentators (and others in general) to ascribe intrinsic significance to the negligence rule, or to whatever their preferred tort rule is. Commentators' statements are not represented as reflecting solely the functional values of tort rules and the tastes of the population for the rules. To be sure, the functionality of rules is usually mentioned by commentators, but it is only one part of the argument that they advance.

Has social decisionmaking been harmed in a substantial way because of the view of commentators? I think that the answer is yes. To illustrate, it seems to me possible that the general scope of tort liability is too great because of commentators' orientation.

³⁸See section 6 of chapter 11.

³⁹For instance, I said that if administrative costs are high, it may be best not to estimate losses, and on certain further assumptions not to include certain components of loss in damages; see sections 7 and 8 of chapter 10.

For instance, in substantial domains that I noted earlier, such as automobile accidents and product harms to consumers, the extent of liability may well be too wide: First, tort liability may provide little deterrence (in the automobile case, because people worry about harm to themselves in the first place; in the product context, because reputational concerns of firms may lead them to take precautions in the absence of liability, and government could provide consumer information). Second, tort liability is very expensive as a means of compensation compared to the insurance system. Third, the true taste for tort liability may not be strong, and greatly compromised by the presence of insurance. In the face of this, why do we not have a more restricted set of circumstances in which liability is imposed? An answer is that the tort system that we observe is the product of invocations of corrective justice by commentators, judges, and others of influence, rather than an objective assessment of its importance as a taste, set off against conventional social welfare considerations. Whether or not I am right about the conjecture that the degree to which we use tort liability is excessive is not really important. My true point is that I *could* be right: Because there is little real consideration given by commentators of the true instrumental benefits of liability, and no real attempt to assess the taste for corrective justice, errors in evaluation can be made.

3.3 Contracts. The notion of morality that is most relevant in the context of contract law is that of promise-keeping: that it is right to keep promises and wrong to break them. The translation of this moral norm into contract law is that one is supposed to honor a contract and not breach it, and if one does breach it, that one should suffer a sanction. What this sanction should be, according to the promise-keeping norm, is not entirely clear, and some subsidiary principle has to be used to determine it.

How moral notions ought to be taken into account. The way that this moral notion ought to be taken into consideration is that, whatever weight conventional analysis would lead one to accord to keeping contractual promises due to the instrumental benefits flowing from so doing, extra weight should be given to keeping such promises owing to the taste for promise-keeping. Second, whatever level of damages for breach of contract is best according to conventional analysis would be altered in the direction of the level of damages for which there is a taste.

What do these general observations imply? The answer depends on what the understanding of breaking a contract is to individuals. Consider the example of a contract that reads something like, “I will produce a machine for you.” One understanding of breaking a contract, the standard one, is that if the machine is not delivered, then the contract is breached. Under this understanding of breach, the promise-keeping norm says that breach is wrong, and consequently should not come about. The implication of this view is that whatever level of damages I said was desirable is too low, for I said that breach of this type of contract is often desirable, and damages should be chosen so as to allow an escape hatch that will lead to breach whenever the cost of performance exceeds the value of performance; see chapters 13 and 15. This is why, in the paradigm case, I said that expectation damages are desirable; they lead to breach whenever the cost of performance exceeds its value to the promisor. Thus, the promise-keeping norm would lead us to say that damages should be higher than expectation damages, so as to lead to more frequent performance.

The importance of this argument for raising damages above expectation damages depends on the true taste individuals have for keeping promises, and remarks analogous

to those above about the importance of corrective justice apply here. Namely, it is not clear that individuals have thought carefully about how important they believe promise-keeping is, that their statements probably do not reflect a true parsing of the instrumental from the intrinsic importance of promise-keeping. I should observe also that, when individuals name liquidated damages for breach, such damages are often fairly low, and very often equal expectation damages, suggesting that individuals do not strongly want to induce promise-keeping, but rather to allow breach when the cost of performance would be excessive.

Finally, let me comment that this discussion has been premised on the standard interpretation of breach, that not honoring the words of the contract is a breach. However, it is possible that a deeper view of a contractual arrangement is held by some individuals, under which the contract is interpreted in the way that I did in chapter 13. Namely, the contract is regarded as an incomplete promise, and it reads as it does only because of the inconvenience of writing a completely specified contractual promise. Under this view, the breach of the incomplete contract, such as “I will produce a machine for you,” is not a true breach. A true breach would be not honoring the completely specified contract that would have been written had the parties included all relevant contingencies. Under this completely specified contract, the obligation to produce the machine would hold only when production cost is less than the value of performance; otherwise there would be no obligation to produce it. Hence, the promise-keeping norm would turn out to imply that one should obey contracts and perform only if the cost of performance is below the value of performance, and thus would be consistent with the economic analysis of contracts. But this view of contracts and promises is not the one that is in fact held by very many individuals in my experience (even though I think it is the view that ought to be held).

How moral notions are actually taken into account. In fact, the way that moral notions are taken into account in contract law has distinct aspects. First, the language of commentators suggests that breaking the agreements that are written, such as that I will produce a machine for you, is viewed as bad.⁴⁰ Thus, we see criticism of the idea that it is permissible to break a contract as long as one pays damages. If, consistent with this view and the seeming strength with which it is often expressed, damages for breach were really high, or if specific performance were widely employed as a remedy, then contract law would be very different from what it is; contracts would be performed much more often, breach would be much less common than it is.

This leads to the second point about moral notions and contract law. Namely, when it comes to damages, the commentators seem usually to endorse the view that damages should equal the expectation measure (or sometimes the reliance measure), not that damages should be so high as to induce performance.⁴¹ Thus, there is tension between the commentators’ view that damages should be moderate but that contractual promises ought to be kept.

⁴⁰See, for example, Barnett 1986 and Fried 1981; and see the views about promise-keeping of such philosophers as Kant [1785] 1997, 15,32,38, and Ross 1930, chapter 2.

⁴¹For example, Fried 1981 endorses the expectation measure.

In any case, because of the opinion that damages should be moderate, there does not seem to be a general, socially disadvantageous effect on contract law flowing from the application of morality to it. However, there are many particular instances of socially undesirable aspects of contract law that are probably influenced by notions of morality, but these we will not discuss here.⁴²

3.4 Public law enforcement and criminal law. The notion of morality that is most important in regard to public law enforcement and crime is retributivist, that wrongdoing merits punishment, and the punishment should be in proportion to the gravity of the bad act. The proportion could be one to one, as under the biblical principle of an eye for an eye, or different, typically higher. Of significance is that the level of punishment depends on the degree of wrongfulness of the act and not on other factors, notably, not on the likelihood of punishment or on the cost of imposing it.

How moral notions ought to be taken into account. Whatever was the optimal level of sanctions from the point of view of our previous analysis should be modified somewhat to reflect the taste for retributive justice. This might mean that the sanction should be lowered from what I suggested was optimal. This would be the case, importantly, where a low likelihood of catching violators and imposing sanctions on them leads to the desirability of sanctions substantially exceeding harm. Recall from chapters 20 and 21 that we concluded that it is desirable for sanctions to equal the harm multiplied by the reciprocal of the probability of punishment (or something reflecting that in the case of nonmonetary sanctions), so that, for example, if the chance of being caught is one third, the sanction should equal three times the harm. This can easily lead to a level of sanctions exceeding that given by the proportionality criterion of retributive justice. For instance, the optimal sanction for tax cheating might be many times the understatement of the tax due, and the optimal sanction for stealing a car might be a significant number of years in jail. Taking account of the proportionality principle would reduce these conventionally optimal sanctions.

Note, however, that if sanctions should be smaller than the conventionally optimal magnitude, due to our taste for retributively correct punishment, achieving more deterrence would require investing more resources in enforcement to catch violators of law. If we can only impose a sentence of one year on a car thief even though a three year sentence would be more appropriate for purposes of preventing such theft, given the present probability of apprehension, we had best increase the likelihood of apprehension of car thieves even though that involves extra expense. This general implication of retributive tastes is of special note because, as I emphasized in earlier chapters, the nature of the conventionally optimal enforcement policy involves low likelihoods of catching violators to save enforcement resources, and accompanying high penalties to maintain deterrence. Retributivist tastes moderate the use of this strategy because these tastes increase the effective cost of raising penalties above a fair level.

An opposite possibility, that retributive tastes might lead to higher sanctions than called for under the conventional social welfare calculus, arises in several circumstances.

⁴²One important example is the notion that damages should not be altered from their fair level for reasons having to do with incentives. Thus, suppose that expectation damages are felt to be correct, but it turns out that breach (such as improper quality of service of the promisor) would often go undetected. In such a situation, the two parties might want to specify a multiple of expectation damages as liquidated damages in order to provide proper incentives to perform. This, though, might be seen as unfair and not honored as the measure of damages.

One is where individuals are certain to be caught and the correct proportion of punishment under retributivist principles exceeds one hundred percent. For instance, suppose a firm knowingly pollutes a lake, causing \$1,000,000 of harm. Here the economically optimal fine is \$1,000,000, but the retributively-best punishment is by hypothesis higher, such as \$2,000,000. A closely related reason why the retributive punishment might exceed the economically appropriate one has to do not with the proportionality factor, but rather with the assessment of the gravity of the act. Although the harm caused by the pollution might be \$1,000,000 and the proportionality factor might be one, the retributively best punishment might be \$2,000,000 because the assessment of the gravity of the firm's act might be high if the firm's behavior had an outrageous aspect, for instance, if its employee was drunk. Another reason that the retributively appropriate punishment might exceed the economically optimal one is that the costs of imposing punishment might be too high to make any punishment, or much punishment, worthwhile, whereas retributivist principles are not influenced by the cost of punishment.

How much the conventionally optimal punishments should be modified depends upon our taste for retributive justice, and it is hard to know what this is because of our ignorance of the degree to which individuals separate their desire for appropriate punishment from that for the consequences that punishment brings about, principally in terms of deterrence and incapacitation.

How moral notions are actually taken into account. It appears to me that our notions of correct punishment have considerable effect on our punishment policy. Certainly this is clear from the rhetoric surrounding punishment. Many punishments are much lower than they ought to be according to conventional economic thinking. The penalties for tax cheating are a good example; these are quite small, even though the chance of being found out for that misbehavior is slight. Likewise for many criminal acts, for automobile theft for example, sanctions may be inadequate given the likelihood of capture. Because the probability of catching many types of violations is so low, the needed sanctions for deterrence are often very high, come into conflict with our notions of fair punishment, and these notions are given substantial weight.

If sanctions are inappropriately constrained by retributivist thinking -- more than is merited by our true tastes for retributivist principles -- then society suffers from a number of disadvantages. First, deterrence and incapacitation are too low, relative to what they ought to be. Second, expenditures on enforcement are greater than needed, because we are unwilling to raise sanctions in many areas, which would allow us to lower enforcement expenditures. Consider the enforcement of parking violations. If we were willing to double the magnitude of tickets for parking too long at a metered space from their usual level of about \$20 to about \$40, we could halve enforcement effort, which is substantial in our country, and use these freed resources in other areas, or save taxpayer money, without altering deterrence. While mundane, this example illustrates one way in which society is paying for its desire to employ proportionate sanctions.

When the sanctions that are felt to be fair exceed those that make economic sense (rather than fall below the economically optimal sanctions), society also suffers a cost. Perhaps the best example is that of firms that cause harm and suffer large penalties, such as punitive damages, making their financial burden exceed harm done. What this

produces is excessive precautions, high product prices, and withdrawal of firms from socially valuable lines of business.

These costs to society in terms of social welfare, conventionally measured, are the price we pay for proportionality of punishment. I have suggested that the costs are substantial, and that they are not warranted by the actual taste we have for proportionality. To know whether the conjecture is correct, we would have to assess the strength of that taste, something that, as with the other moral notions, has not been done to my knowledge.

3.5 Influence of law on moral beliefs and their effectiveness. I noted above that, to some degree, the law can influence moral beliefs and that it can also alter their effectiveness by leading individuals to act on their beliefs to impose social sanctions on those who deviate from moral behavior. This has obvious implications for the design of the law, for it constitutes an effect of a legal rule that must be reckoned in the calculus of its design, along with other consequences. For example, in assessing the desirability of passage of civil rights laws, one would take into account not only their direct effects on behavior, such as changes in the hiring practices of businesses to avoid liability, but also that the laws may serve to alter basic beliefs about race and individual rights, as well as the willingness of individuals to admonish those who discriminate.⁴³ However, one suspects that in most instances, unlike in that of the civil rights laws, the influence of a legal rule on moral beliefs is a minor, if nonexistent, factor.

4. The Nature of Normative Discourse about Law and Morality

What has been suggested above to be the proper approach to understanding the relationship between law and morality, and especially how best to design the law, is quite different from the approach to these issues that is commonly found, whether in the classroom, scholarly journals, legal opinions, or other forums. Here I want to characterize briefly salient aspects of the normative discourse about law and morality that we encounter, contrast it with the welfare economic view, and attempt to explain why the nature of actual normative discourse is what it is. This will help to reconcile the differences that exist between the usual normative views and the welfare economic view, and I hope will lead the reader in the direction of endorsement of the welfare economic view.

4.1 Characteristics of observed discourse. Normative discourse about law and morality appears to have three general characteristics. The first is that independent weight is given to moral factors. For example, when crime is discussed, the blameworthiness of criminals and the proportionality of punishment are typically accorded independent importance, or when the subject of torts is addressed, corrective justice and compensation of victims are accorded significance of their own. The second characteristic is that the moral factors typically are not adequately distinguished from the instrumental ones. For instance, when a person says that punishment for car theft ought to be a five year

⁴³Of course, a necessary part of this calculus is evaluation of the social value of the changed moral beliefs themselves. In essence, such evaluation involves taking into account the direct effect on utility of the moral beliefs (consisting of the experience of virtue for doing right, here of not discriminating, or of guilt for doing wrong, and of associated feelings with respect to giving praise or admonishing others), and taking into account the indirect effects due to behavioral changes induced by the moral beliefs.

sentence, it will be unclear to what extent this reflects the person's view of just punishment and to what extent it is based on his judgment about conventional economic factors, notably, deterrence, incapacitation, and enforcement costs. The third characteristic of observed normative discourse is that it is generally not neutral in its tone. When individuals debate issues of legal policy, their interchanges frequently include elements of moral suasion. I am certain that the reader has seen that when a person advances a right as a reason for this or that legal policy, the person typically evinces feelings of virtue on his own part -- in his tone of voice, in his rhetorical and expressive style. Likewise, if a contrary view is advanced by another person, that person is subjected to attack, and certain types of social sanctions are imposed that are not entirely dissimilar to those experienced by individuals who have acted immorally in reality. In other words, the person advancing a morally incorrect legal policy is subjected to a translated form of the social sanction that he would suffer if he had actually acted immorally.

4.2 Chief difference between observed normative discourse and the proper normative view. Perhaps the principal difference between what we encounter in observed normative discourse about law and morality and the views that I have been expressing is that the psychological aspects of morality and the instrumental role of moral notions are generally ignored in the observed discourse. In this discourse, there is usually no acknowledgment made of the point that individuals have tastes for satisfaction of notions of morality and that the notions may serve to promote social welfare.

4.3 Explanation for the difference. It is not mysterious that there should be this difference. Since we care about adherence to moral notions, at least if we are well-socialized individuals, it is natural for us to import our feelings about them into the realm of analytical discussion. Suppose that we believe that there should be no punishment without fault and that punishment should be in proportion to the gravity of bad acts. Then if one of us becomes a legal academic, or an editorialist for a newspaper, it might be expected that we would carry our views into our professional writing concerning legal policy. This simple observation also helps to explain the non-neutral character of observed discourse about normative legal issues.

By contrast, the view of morality that I have been advancing is not a natural one for individuals to hold. For it requires us to place ourselves on the psychiatrist's couch in order to examine why we ascribe the importance that we do to moral notions. Because this is a difficult exercise, it is not entirely surprising that it is so infrequently done. Yet it is somewhat surprising that academics have paid so little attention to the view advanced here, for it is in many respects a well-known view. Famous philosophers have developed important elements of the view of morality presented here -- I refer especially to Hume ([1751] 1998), Smith ([1790] 1976), and Mill ([1861] 1998), and more recently to such writers as Hare (1981).

4.4 Conclusion. My conclusion is that welfare economics, as described in the previous chapter and this one, provides an intellectually attractive and generally satisfactory lens for understanding and analyzing morality and law, in part because welfare economics allows one to pass behind the veil of morality into an inquiry about its functions and origins. Although I realize that this view is in tension with the great weight of authority, it is the only one that I can comfortably endorse, and I hope that the reader appreciates its value, even if the reader does not come to accept it.

Chapter 28

INCOME DISTRIBUTIONAL EQUITY AND THE LAW

Let me now turn to the topic of the distribution of income and the legal system. Here the question to be addressed is how the effects of legal rules on the distribution of income should influence the choice of legal rules. I will first review how the distribution of income enters into the determination of social welfare, and also how the income tax and transfer system can be utilized to achieve income distributional objectives. Then I will discuss the influence of legal rules on the distribution of income and whether the choice of legal rules should be influenced by their distributional effects. The main point will be that income distributional objectives are best pursued through the use of the income tax and transfer system, implying that legal rules should be selected on the basis of objectives apart from the distributional.⁴⁴

1. The Distribution of Income and Social Welfare

Most concerns about the overall distribution of income can be accommodated by, and are embodied in, the measures of social welfare of conventional welfare economics, as was mentioned in section 1 of chapter 26. In particular, there are three channels through which the distribution of income may influence social welfare.

First, the distribution of income may matter to social welfare because the poor may value a dollar more than the rich -- the marginal utility of a dollar to a poor person is likely to exceed the marginal utility of a dollar to a rich person. If so, social welfare will tend to be increased by redistributing income from the rich to the poor.⁴⁵

Second, the distribution of income may matter to social welfare because the distribution of income affects the distribution of *utility*, and under the welfare economic approach social welfare may depend directly on how equally utility is distributed among individuals. Thus, even if the rich and the poor obtain the same marginal utility from a dollar, it may be desirable to redistribute from rich to poor because the rich enjoy greater overall utility.⁴⁶

⁴⁴The questions discussed in this chapter are ones that fall under the head of conventional welfare economics, and do not involve issues of morality in the sense in which I have used this term in previous chapters. Nevertheless, because the distribution of income is usually described using words such as “equity” and “fairness,” it seems natural to treat the relation between law and income distribution in this part of the book.

⁴⁵For example, consider the classical utilitarian social welfare function, the sum of utilities. Under it, redistributing a dollar from a rich individual with a low marginal utility of income to a poor individual with a high marginal utility of income will raise social welfare, for the utility of the rich individual will fall by less than the utility of the poor individual will rise, meaning that total utility will be greater.

⁴⁶Suppose that social welfare equals the sum of the square roots of utility (this is a social welfare function under which more equal distributions of utility are desirable; see note 5 of chapter 26). Suppose also that the utility of a person equals simply his level of wealth (so that the marginal utility of a dollar is 1, regardless of whether a person is rich or poor). Now consider two individuals, one who has wealth of \$100 and the other wealth of \$1,000, and suppose that \$100 is transferred from the wealthy person to the poor person, so that the former is left with \$900 and the latter possesses \$200. The \$100 gain by the poor person raises his utility by 100, which is exactly the loss in utility for the rich person, so the redistribution does not lead to any change in the sum of utilities. Yet, because the redistribution makes the distribution of utilities more equal, it raises social welfare:

Third, the distribution of income may matter to social welfare because an individual's utility may depend on the distribution of income in the population at large, owing to generalized feelings of altruism or of sympathy. Thus, even if the rich and the poor obtain the same direct marginal utility from a dollar, and even if social welfare equals the sum of utilities and thus does not depend in an intrinsic way on the distribution of utility, it may still be true that social welfare may rise if the distribution of income is more equal.⁴⁷

In what follows, it will not be important to refer to the particular source of importance of the distribution of income to social welfare; I will simply assume that the distribution of income enters into the determination of social welfare.

2. The Income Tax System, Income Distribution, and Social Welfare

2.1 The income tax system. By the income tax and transfer system is meant the combined effect of the various taxes (federal, state, and local) on income, together with programs (such as Medicare, food stamps) that effect transfers of money to individuals based upon their income. For brevity, I will speak of these taxes and transfers simply as the income tax system.

There are two chief purposes of the income tax system: to raise revenues for purposes of the state, and to redistribute income.⁴⁸ The second purpose may not seem important to some readers, perhaps because few individuals receive outright transfers and because there is relatively little frank discussion in public forums of the tax system as a means of redistribution. However, a moment's reflection makes one realize that the tax system does in fact possess substantial redistributive effects -- the situation of many individuals, especially of the poor and of the rich, is changed significantly by the existence of the tax system and government activity, and it is certainly clear that the tax system can be used to redistribute.

social welfare is originally $\%100 + \%1,000 = 10 + 31.62 = 41.62$, and rises after the redistribution to $\%200 + \%900 = 14.14 + 30 = 44.14$.

⁴⁷For example, suppose that the utility of each person equals the sum of two components: his own wealth (which he spends on personal consumption), and the sum of the square roots of the utilities of all individuals (that is, the measure of social welfare discussed in the previous note). Notice, therefore, that the direct marginal utility of a dollar for a person is 1, regardless of his wealth, for the first component of utility is equal to his wealth; but the utility of a person also depends on the distribution of utilities in the population through the second component of his utility. Suppose too that social welfare is utilitarian, the sum of utilities, so that, as stated in text, social welfare is insensitive in a direct sense to the distribution of utilities. Then, as stated in the text, social welfare rises if wealth is more equally distributed because that tends to raise individuals' utilities, and thus the sum of utilities, for the individuals' utilities (as opposed to social welfare) depend on the distribution of utilities and thus on the distribution of wealth. For instance, suppose that, initially, one person has wealth of 0 and the other 1,000. The utility of the first person is $0 + \%1,000 = 31.62$, and that of the second is $1,000 + \%1,000 = 1,031.62$, so, considering these two people, social welfare is 1,063.24. If wealth is redistributed so each person has 500, the utility of each is $500 + 2\%500 = 500 + 2(22.36) = 544.72$, so social welfare is 1,089.44, which is higher.

⁴⁸When I say redistribute income, I mean to include wealth as well as income.

2.2 The income tax system and optimal redistribution. To see how the income tax system can be employed to redistribute income, let us suppose for simplicity that redistribution is its sole purpose (that is, let us abstract from the government's need to raise revenue) and consider the following problem: Design the income tax system to maximize social welfare, assuming that the measure of social welfare is one that favors equality of income; thus, if a fixed amount of income exists to be divided, the best way to divide it would be equally.⁴⁹

To solve this problem, suppose first that the income that each individual earns is fixed in quantity. Then, the total income of individuals is obviously fixed, implying that the optimal income tax would be designed so as to give all individuals an equal income, namely, the average income. If, for instance, the average income were \$20,000, then any person earning over \$20,000 would pay in taxes the excess earned over \$20,000, so that he would be left with \$20,000, and any person earning less than \$20,000 would receive enough to bring him up to \$20,000. Thus, the income tax would be employed to achieve the ideal distribution of income, and associated with it, the ideal level of social welfare.

There are, however, two important reasons why the income tax system cannot achieve the ideal level of social welfare. One concerns the administrative costs of taxation. Suppose that transferring a dollar among individuals via the tax system involves an administrative cost (because individuals have to fill out tax forms, incomes must be verified to combat evasion, and so forth). Then it is clear that the social welfare-maximizing income tax system will not result in an equal distribution of income, for that would involve too great a loss due to administrative costs. In general, the optimal income tax system will strike an implicit balance between the social benefits of redistribution and the administrative costs of redistribution; therefore, the level of redistribution and social welfare achieved will fall short of the ideal. This point may be helpfully described in terms of the metaphor of a leaky bucket: When transferring income in buckets for the purpose of redistribution, some income leaks from the buckets and is wasted, so it is not desirable to carry as much in buckets as society otherwise would want. Another metaphor is that the size of the pie to be divided among the population, that is, the sum of incomes, shrinks when the pie is divided.

The second reason why the income tax system cannot be employed to achieve the ideal level of social welfare through redistribution concerns distortion of work incentives. Although it was assumed in the previous paragraphs that the earnings of each individual were fixed, this is unrealistic, and let us now assume that a person's earnings depend on how hard he works and on his ability. In this situation, the income tax may alter work incentives and thus earnings. Notably, a person who has to pay a substantial percentage of earnings in taxes, such as 50 percent, may well work less hard, and earn less, than if he paid no income taxes; and a person who will receive a payment if his earnings fall below some threshold might have diluted incentives to work relative to what they would be if he would not receive this payment. Hence, the use of the income tax to redistribute may lead to a reduction in work effort and earnings, and through this route, reduce the total amount of income available to redistribute. Therefore, when one takes into account how the income tax influences work incentives in solving for the optimal income tax, it turns out

⁴⁹One measure of social welfare under which this would be so is, as mentioned, the sum of the square roots of utilities; see note 3 above.

that the level of redistribution and social welfare falls short of the ideal.⁵⁰ In a rough sense, the reason is similar to that due to administrative costs; the distortion of incentives is in effect another source of leakage from the buckets used to redistribute.

A comment about the work incentive factor should be made. Economists sometimes emphasize the point that this problem can be viewed as due to inability of the tax authorities to determine the innate ability to earn of individuals. The reason is that if a person's ability to earn could be observed, the tax could be based on this ability and not on actual income earned. For instance, a person who has the ability to earn \$100,000 a year and who would earn this amount in an ideal world, and for whom in that world the ideal tax would be, say, \$50,000, would face an unconditional flat tax of \$50,000, not a tax based on income earned. Hence, he would not have a disincentive to earn, because he would face the \$50,000 tax based on his ability and could not escape the tax by working less hard. In reality, however, government cannot observe innate ability and earning capacity, and it must largely base taxes on earned income.⁵¹

In summary, then, we can say that the optimal use of the income tax to redistribute income does not lead to an ideal distribution of income because of two costs associated with redistribution: administrative costs and the implicit costs of the dulling of work incentives.

3. Effect of Legal Rules on the Distribution of Income

3.1 In general. It is clear that legal rules generally affect the distribution of income. If we trace out the consequences of any legal rule for each income class, we can determine its effects. Consider, for example, a rule that makes owners of large recreational boats liable for harms they negligently cause. This rule leaves the large recreational boat owners less well off both because they will be led to spend on safety equipment and to take precautions that they would not otherwise have taken, and because they will have to pay for any negligently caused accidents that still result; and it will benefit possible victims, including small boat owners and swimmers, because they will suffer from accidents less often and, if involved in accidents, will sometimes be able to

⁵⁰This problem was first formally studied by Mirrlees 1971 and emphasized by Vickrey 1947; it has been developed in a vast literature known as the "optimal income tax literature." In this literature, the standard model is as follows. Each individual has an unobservable-to-the-government ability to work a . His earnings y equal aw , where w is work effort (thus, the higher his ability, the more he earns), where w is also unobservable. Work effort involves an effort cost to him of $c(w)$. He pays an income tax $t(y)$, which could be negative (corresponding to receipt of money). Thus, an individual will choose work effort w to maximize his net utility: $y - t(y) - c(w) = aw - t(aw) - c(w)$. Clearly, the individual's choice of w will depend on the tax schedule $t(y)$, and it will also generally depend on his ability a . Denote this net utility of a person of ability a who chooses his work effort given the tax schedule t by $u(a,t)$, and denote the person's choice of work effort by $w(a,t)$. The problem of the government is to choose the income tax schedule, that is the *function* $t(y)$, so as to maximize social welfare, subject to the constraint that taxes collected sum to zero (that is, what is collected equals what is given out). Social welfare can be expressed as $\int W(u(a,t))f(a)da$, where $f(a)$ is the probability density of individuals of ability a . The condition that taxes net to zero is $\int t(aw(a,t))f(a)da = 0$.

⁵¹Society can and sometimes does base income taxes on certain observable indicators of earning capacity. For example, the blind have a lower earning capacity than those with sight, so we do not tax them as heavily (and perhaps there are other reasons why that makes sense as well). However, society does not make use of all observable indicators of earnings capacity, such as educational attainment. Using that factor might be undesirable; for instance, it would discourage educational attainment, and this has benefits to individuals apart from how it raises earning power. In any event, I will abstract from such considerations in the text.

collect. Because the large recreational boat owners will tend to be a wealthy class, and their potential victims will not, the rule will redistribute from rich to poor; a refined understanding of this effect could be ascertained from data on who purchases large recreational boats and from data on victims of accidents. In such a manner, the influence of any legal rule on the income distribution can be determined.

3.2 Comments. Several remarks about the assessment of the distributional effects of legal rules are worth bearing in mind.

Diffused effects. Although in the example concerning recreational boats, the distributional effects of the legal rule might be fairly clear, because the injurers and the victims might be expected to comprise reasonably distinct income groups, that is not always so. Consider, for example, the effects of use of the negligence rule for accidents involving cars and pedestrians. This rule of liability imposes costs on drivers and it benefits pedestrians, but drivers constitute an extremely diverse group by income, and so do pedestrians. Moreover, drivers and pedestrians are not even distinct groups -- most drivers sometimes walk and most pedestrians sometimes drive. Thus, the distributional effects of the legal rule concerning drivers and pedestrians might be quite diffuse.

Attenuated effects in contractual contexts. Another general observation about distributional effects is that if legal rules affect parties who are in a contractual arrangement with each other, the effects may be muted or even eliminated by changes in contract prices. Suppose that a legal rule that increases liability of manufacturers of a product for harms to buyers raises their liability-related unit costs by \$100, and benefits buyers by this amount because they collect the \$100 in expected liability payments. If the price of the product did not rise, buyers would be better off and a redistribution would have resulted. But, of course, prices will tend to rise, and in a competitive market they would rise fully by \$100, negating the redistributive effect. It is true that price changes do not always offset the influence of legal rules on prices, but the point here is that there is a significant difference in the distributional effects of legal rules in contractual contexts from the effects in noncontractual settings.

Interrelated nature of, and totality of, effects of different legal rules. Two further comments should be made. First, the change brought about by a legal rule will often depend on other legal rules. For example, the effect of holding drivers liable for negligently caused accidents to pedestrians will depend on speed limits and other traffic laws (the more rigorous they are, the less the influence of the negligence rule) and on legal regulation of vehicle manufacturers (for instance, requiring side-view mirrors on cars, or devices that make beeping sounds when trucks are put into reverse). Second, the income distribution is determined by the totality of effects of different legal rules, many of which work counter to one another. Thus, although car owners may suffer because an antipollution statute requires expensive pollution control devices in cars and raises their prices, car owners may benefit from reduced pollution, and also from other legal rules, such as antitrust rules. In strict logic, the distribution of income is the resultant of the whole legal system, not only of the legal rules that we might think of as variable because they are in flux or are under consideration for modification, but of the whole background of legal rules of property, contract law, criminal law, and so forth that we view as stable and that order our society.

4. Should Income Distributional Effects of Legal Rules Influence Their Selection?

4.1 The general answer is in the negative: Given the availability of the income tax system for achieving distributional goals, legal rules should not be chosen on the basis of their distributional effects. Because society possesses the income tax system for attaining income distributional goals, legal rules do not need to be chosen with these goals in mind. In particular, if there is an affirmative reason to effect further redistribution from the rich to the poor, society can do this with an appropriate adjustment to the income tax, rather than through adoption of this or that legal rule. Moreover, if a legal rule happens to have an undesirable redistributive effect, harming the poor and benefiting the rich, that can be counterbalanced by a suitable change in the income tax system, helping the poor and harming the rich. Thus, there is no evident need to take distributional considerations into account in selecting legal rules.

Further, if distributional considerations were taken into account in choosing legal rules, society would be led to compromise the social benefits that the rules generate, such as lowering the total costs of accidents. Hence, it is not only that distributional effects of the choice of legal rules do not need to be taken into account, it is also that social welfare would be *lowered* by taking those effects into account in the selection of legal rules. Indeed, it can be demonstrated that if distributional effects do influence the choice of a legal rule, it would be possible to make *all* individuals better off by altering the choice of rule to the otherwise optimal rule and by making an appropriate change in the income tax system.⁵²

In view of the importance of this argument against choosing legal rules on the basis of their distributional effects, it is worth considering various complicating factors in the following sections.

4.2 Speed of adjustment of the income tax system. Although undesirable distributive aspects of legal rules can be offset by adjustments in the income tax system, it might take time for the tax system to adjust, and in the period before adjustment, social welfare would suffer. This speed of adjustment factor, then, could in principle lead one to take distributive effects of legal rules into account. Yet it is not obvious why we should expect the income tax system to be slow to adjust, and in fact, it seems to be under more or less constant modification.

4.3 Adjustment of the income tax system to specific legal rules. A closely related consideration that is sometimes mentioned is that the tax system cannot practically be adjusted to offset the undesired distributional effects of specific legal rules.

⁵² A simple version of the argument is illustrated as follows. Consider a world with two equally numerous income classes, rich and poor; a conventionally optimal rule of tort liability that lowers expected accident losses net of costs of precautions by \$20 per person, which is as much as possible, and that otherwise leaves incomes unaffected; and a second liability rule that lowers net accident losses by only \$10 per person but that reduces the wealth of each rich person by \$50 and raises the wealth of each poor person by \$50. Suppose that the second rule is selected because its distributional effects are preferred. Our claim is that all individuals can be made better off if, instead, the optimal rule is chosen. In particular, suppose that, in place of the second rule, the first is chosen and income taxes are raised by \$50 on the rich and lowered by \$50 on the poor. Then each poor person is better off under the optimal rule than under the other rule, for the reduction by \$50 in income taxes compensates for the loss of the \$50 benefit from the rule, and his accident losses fall by \$20 instead of only by \$10. Likewise, each rich person is better off under the optimal rule, for the increase by \$50 in income taxes is offset by the \$50 benefit from the optimal rule, and his accident losses fall by \$20 instead of only by \$10. This argument is easily shown to hold generally where incomes of individuals are fixed, rather than a function of work effort, but it carries over to the latter setting as well; see section 4.6 below.

Hence, it is asserted, there is some reason for the distributional effects of the choice of a legal rule to be taken into account in its selection. This line of thinking, however, is insufficiently articulated to be well understood, and when one attempts to amplify it, one is left wondering about its meaning. For example, an important reason why it would be impractical to alter the tax system in response to each and every choice of legal rule is that some administrative cost is involved in so doing; another reason is that different legal rules often have counterbalancing effects, so that it may be desirable to wait for some period to see their cumulated effect before adjusting the tax system. But both of these reasons would also apply to a court or a legislature in designing legal rules. They would face administrative costs in determining the distributional effects of legal rules, and they would need to assess the cumulated effect of different rules, not just an isolated rule at a moment in time.

4.4 Administrative costs. Administrative cost considerations may bear on the comparison of legal rules and the income tax system for the purpose of altering the distribution of income. If it were the case that legal rules allowed income to be redistributed more cheaply than the income tax system does, then the conclusion that legal rules should not be chosen on the basis of their redistributive effects would not necessarily hold. Conversely, if it were the case that legal rules involve greater administrative costs in connection with redistribution than the income tax system, the conclusion that legal rules should not be selected on the basis of distributional effects would be reinforced.

The question at issue, therefore, is how the administrative costs of legal rules and of the income tax system compare, and several remarks can be made about this. First, the administrative costs of the income tax system (as distinct from distortions in work effort that it causes) are not negligible, probably more than 5 percent of dollars collected.⁵³ Second, the administrative costs of redistribution through use of legal rules should be divided into two components. One is the administrative cost of redistribution through litigation and settlement, and, as discussed earlier in chapter 12, this is very high, on the order of 100 percent. But the other way that legal rules redistribute is through effects on behavior, for instance, by inducing injurers to take precautions. This would not usually seem to involve such substantial administrative costs. The administrative costs of redistribution through use of legal rules is thus some compound of high expense and low, and depends on the rule in question.

4.5 Multiplicity of legal rules. A factor that supports the general argument against use of legal rules to redistribute income is the numerousness of legal rules, for this complicates the task of assessing their distributive effects. If legal rules were chosen individually, on the basis of their particular effects on income distribution, needless social losses would result, especially because of failure to take into account the offsetting effects of different rules.⁵⁴ Because legal rules are affected by different legislative bodies

⁵³See Slemrod and Bakija 2000, 134-38, for estimates of the costs to government and to taxpayers of the tax collection process.

⁵⁴For example, suppose that initially, the distribution of income is thought to be desirable and at time 1, there is a choice between two rules A1 and B1, where A1 is superior on nondistributional grounds but would favor the rich. Hence, the rule B1 might be chosen if distribution is taken into account, so that the rich do not become richer. Suppose too that at time 2, there is a choice between two rules, A2 and B2, where A2 is superior on nondistributional grounds and favors the poor. At this time, we could imagine that B2 might be chosen, to

and are also shaped by courts, one does not have confidence that the choice of legal rules to accomplish distributional objectives is, or would be, done in an integrated way that reflects the summed influence of different rules.

4.6 Distortion of work effort under the income tax and consequent less-than-ideal income distribution. As explained above in section 2.2, the income tax distorts work effort, and as a result, the distribution of income that results under the optimal income tax system involves inequality; although an equal distribution of income may be possible to achieve, it is generally not optimal because it would dilute work incentives too much. This raises the question of whether legal rules should be selected in part so as to bridge the gap between the distribution under the income tax and what is socially ideal. Somewhat surprisingly, perhaps, the answer to the question is no; it remains true that legal rules should not be selected on the basis of distributional effects.

The kernel of the explanation is that if legal rules are chosen to redistribute, this too will distort work effort. If, for instance, those who earn an extra \$1,000 know that they will pay \$500 more due to legal rules (say they will pay more in tort damages if they are held liable), then this will reduce their incentive to earn the \$1,000 just as much as if they had to pay \$500 more in income taxes. Whether it is the income tax arm of government or the judicial arm that takes the \$500 is of no consequence to a person; it is the fact that earning \$1,000 more will result in \$500 of that amount being taken that reduces the person's incentive to work. Using legal rules to redistribute income distorts work incentives just as much as the income tax does. But using legal rules to redistribute *also* tends to interfere with achievement of the beneficial purposes of the legal rules, notably in channeling behavior. Hence, it is best to use legal rules to achieve the beneficial purposes for which they are directly intended, and not to select them on the basis of their distributional effects.

I should add for clarity that this point has been formally established in a version of the standard model of the income tax and distortion of work effort. In that model, the following conclusion (an extension of the conclusion mentioned in section 4.1) holds: Suppose that there is an income tax system in place and that a legal rule that is not conventionally optimal has been selected. If that rule is replaced by the conventionally optimal legal rule and the income tax system is suitably modified, *all* individuals will be made better off. This conclusion is stronger than what was discussed in the previous paragraphs of this section in that it states that all individuals can be made better off if legal rules are not selected on the basis of distributional considerations.⁵⁵

prevent the previously corrected income distribution from being again upset. Thus, we could imagine two inferior choices of rule, favoring B1 and B2, even though the superior rules, A1 and A2, have opposite distributional effects that would be exactly offsetting.

⁵⁵This result is first shown in Shavell 1981 and is amplified and discussed in Kaplow and Shavell 1994c; it builds on a result in the optimal income tax literature shown in Hyllund and Zeckhauser 1979. The model used in Shavell and in Kaplow and Shavell is that of the optimal tax literature, as described in note 7 above, but in which there is included as well an activity controlled by a legal rule. Specifically, individuals choose a variable x called care that reduces harm to others $h(x)$ but that involves disutility $d(x)$ to them. The legal rule imposes a liability cost $l(x)$ on them. Let l^* be the "efficient" legal rule -- that which results in minimization of $h(x) + d(x)$ summed across the population. And let t be any income tax schedule. Now let $l//$ be any alternative legal rule that is not efficient -- such as one chosen because of its distributional characteristics. Then there exists a modified tax schedule $t//$ such that, under $t//$ and the efficient legal rule l^* , *all* individuals are better off than they are under t and the inefficient rule $l//$. As we discuss in Kaplow and Shavell, this conclusion does depend on a separability

4.7 Political process that determines the income tax is not socially desirable.

One occasionally encounters the argument that the income tax is set by an imperfect political process and that, as a consequence, the income tax schedule does not lead to optimal redistribution. Therefore, the argument continues, legal rules should be chosen at least in part on the basis of their distributive aspects, so as to correct for the problem with the political process. This argument, however, overlooks the ability of those with political power to neutralize attempts by those controlling legal rules to redistribute income. If legal rules were used in an attempt to take more from the rich and give to the poor, one presumes that those who control the income tax could offset this effect by reducing tax rates on the rich to compensate them for the extra burden they suffer under the legal system. Thus, in the end, those who would choose inefficient legal rules in order to redistribute income would only cause a loss in social welfare and not accomplish additional redistribution. If, however, one assumes that the political process is not only imperfect in failing to achieve society's redistributive goals, but also imperfect in failing to offset attempts to redistribute through the choice of legal rules, the argument just stated would not apply.

4.8 Conclusion. The initial point made here that legal rules should not be selected on the basis of their income distributional effects is somewhat qualified, and is in certain respects reinforced, by consideration of a number of factors that bear on it. In particular, we found that where the administrative costs of the income tax system exceed those of legal rules as a means of transferring income, then legal rules might be selected on the basis of their distributional effects; and that if the speed of adjustment of the tax system were slow, the same might be said. The reader may judge for himself or herself the relevance of these two points. We also found that the multiplicity of legal rules and the need to coordinate responses to them argues against selecting rules on the basis of their distributional effects; that the distortion of work effort under the income tax is also a disadvantage of redistribution through legal rules, and so does not alter our initial conclusion; and finally that asserted defects in the political process also do not alter our basic conclusion that legal rules should not be selected on distributional grounds.

assumption about the disutility of work effort and of the functions determining accidents. That assumption seems the natural one to consider as a benchmark for thinking. In any case, were the assumption relaxed, although the optimal legal rule would not in general be the efficient one, there is no reason for the optimal rule to be such that it would redistribute toward the poor. On the latter issues, see Sanchirico 2000 and Kaplow and Shavell 2000.

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