COMMITTEE IV
A Critical Assessment of
the Achievements of the
Economic Approach

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THE LAW AND ECONOMICS APPROACH

by

Alan Schwartz
Professor of Law
Law Center
University of Southern California
Los Angeles, California

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The Law and Economics Approach

Alan Schwartz*

The nature of law and economics analysis and the contributions of this analysis to legal scholarship generally have become important topics. Law and economics, as an analytic method, originated in the United States, has spread to Canada, England, Israel and Germany and has made beginnings elsewhere. Nevertheless, law and economics is a controversial field. In this favorable review, I shall first briefly describe the history and scope of American law and economics, then explain what the law and economics method is and, lastly, illustrate how this particular analytic method differs from others through a discussion of two related current issues, the scope of the unconscionability doctrine, and the wisdom of allowing recovery for noneconomic losses in products liability cases.

(1) History, Methodology and Values

Law and economics scholarship originated in America in the late 1940s and 1950s to help resolve two relatively specific legal issues: First, should an income tax be progressive--that is, should the percentage of income paid as taxes rise with income--or should the tax be proportional--that is, should the percentage of income paid as taxes be a constant fraction of income?[1] Since in America a strong consensus in favor of progressive taxes existed for many years, this aspect of law and economics analysis, after an early flare-up, became dormant; it

is difficult to call into question what most people believe is holy writ. Today, as the United States Tax Code is becoming much less progressive, law and economics scholars again are taking up the issue of progressivity versus proportionality.[2]

Antitrust law constituted the second garden in which law and economics scholarship initially flourished. The American antitrust laws prohibit anti-competitive acts, which are defined as activities by firms whose intent or effect is to achieve monopoly power or unfairly to exploit monopoly power. A principal task of the economics profession is to understand competitive and monopoly behavior. Since American antitrust law is phrased in the language of economics, blessing competition and restricting monopoly, American lawyers turned to economists for help in deciding what the law prohibited and permitted. Asking economists for such help was thought to be equivalent to asking doctors whether tumors were cancerous or benign. As time passed, American antitrust lawyers began to learn some economics, better to understand the doctor, and American economists began to learn some law, better to understand the patient's needs. The interdisciplinary work that these multi-talented persons produced was the first real law and economics analysis.[3]

Modern law and economics scholarship began in the 1960s at the Yale and Chicago Law Schools. The originator and seminal figure in this movement was Guido Calabresi, whose original idea was to use economics better to understand the purposes and effects of tort law rules.[4] Dean Calabresi possesses the skills of a lawyer and an economist; he studied economics at the

graduate level at Yale and Oxford and also is a graduate of the Yale Law School. The elegance and force of his books and papers, and of Chicago's Blum and Kalvin,[5] were influential in a profoundly different way from previous scholarship. The lesson that American lawyers drew from analyses of antitrust and tax law was that economics could be useful in understanding a small, peculiar subset of legal problems. Calabresi and the Chicago scholars taught that economics could help almost everywhere. If so much progress could be made in such an old and fundamental legal field as torts, scholars concluded that they could better understand many legal fields with the aid of economic techniques. Thus, today, American law and economics scholarship is done in such diverse areas as Contracts, Commercial Law, Criminal Law, Property Law, and Corporate Law. Significantly, much of this work is in private law, a field remote from the public law regulation areas that traditionally concern economists. The nature and scope of law and economics analyses has led many American commentators to regard the movement as representing one of the most significant contributions to our jurisprudence since the end of the Second World War. Indeed, entire industries, such as the critical legal studies movement, have arisen largely to criticize the methodology and results of law and economics analysis.

The questions, then, are just what contribution does law and economics make to legal thought and how is it done. Law and economics analysis has a normative and a positive aspect, and it is essential to distinguish them. The normative aspect begins

with the common sense observation that people's actions bring about states of affairs. An action can be a decision to start a business, purchase a car or pass a law; a state of affairs is what the world is like after the action is taken. Just as there are a very large number of feasible actions available to people at any one time, there are a large number of possible states of affairs that people's actions can produce. The normative aspect of law and economics scholarship is concerned with ranking possible states of affairs as follows: If people have available to them actions that could produce states of affairs X, Y or Z, and if possible state of affairs X is better than possible states Y or Z, people should act so as to bring about state X rather than states Y or Z. Since law and economics scholarship is concerned with the legal order, it focuses explicitly on the contribution of laws to producing states of affairs. For example, if a judge is to issue a decision and has a choice what rule to adopt because the matter is one of first impression, the judge should select that rule that would bring about state of affairs X rather than Y or Z, if X is better than Y or Z.

Law and economics scholarship ranks states of affairs, from better to worse, according to the postulate of individualism. This postulate holds that a state of affairs X is better than a state of affairs Y if the affected individuals prefer X to Y. Thus if there are three people in our society and all prefer X to either Y or Z, then X is the best attainable state of affairs, precisely because the individuals that make up the relevant society prefer X. The postulate of individualism itself derives

from two theories of political morality that have been influential in Western thought, utilitarianism and democracy.

Utilitarianism holds that actions are good insofar as they produce good states of affairs, bad in so far as they produce bad states of affairs. The best state of affairs, according to this criterion, is the one in which citizens experience the highest utility, defined (somewhat loosely) as subjective personal satisfaction. An important branch of the theory, called preference utilitarianism, asserts that (a) people rank the possible state of affairs that their or other people's actions could produce according to the utility criterion, those states being most preferred that generate the most utility; (b) each person is the best judge of what state of affairs yields to him or her the most satisfaction--what state maximizes his or her utility; and (c) people will perform those acts that bring about the best states of affairs, so far as people know what acts actually will do this. The connection between the normative aspect of law and economics scholarship and preference utilitarianism thus is obvious: both use the criterion of people's preferences to rank the goodness of states of affairs, and by inference the goodness of people's actions. And both hold that those states that people prefer the most are the best states.

Utilitarianism has recourse to people's preferences as the measure of utility because subjective personal satisfactions obviously are difficult to measure. It is hard to know how many "units of satisfaction" a person derives from a new car.

Therefore, when a decisionmaker is choosing what action to take--what law to adopt--it is easier for him to learn what state of affairs people most prefer than it is to add up the sums of satisfaction various laws would produce and then enact the law that produces the greatest sum. A person's preferences among possible laws then are taken to be an accurate proxy of the satisfactions the person would experience in the various potential states of affairs that these laws would produce. To the extent that satisfactions can be directly measured, though, both law and economics analysis and the utilitarianism from which it derives yield the same moral criterion: those states of affairs are best in which utility is in fact greatest. But again, because utility is hard to measure, states of affairs are ranked according to the postulate of individualism, which holds that the best states are the most preferred states.

The postulate of individualism that law and economics adopts also is derived from democratic theory, which holds that a polity should choose laws according to the criterion of majority rule. Since people presumably vote for legislators who will enact the laws they prefer--the laws that give citizens the most satisfaction--the normative criterion of law and economics scholarship and that of democratic theory are the same, <u>viz</u>, enact those laws that produce the states of affairs that people most prefer.

The normative aspect of law and economics scholarship thus appeals to persons who are attracted to utilitarianism and democracy as theories of political morality.[6] Americans

traditionally are attracted to both theories, and this may explain why law and economics is so popular there. I would go further, though. People with Western values commonly regard people's preferences as morally relevant to most political choices, either as the criterion by which political choices should be made or as a constraint on those choices when they are made by other criteria. That preferences are relevant, if only as a constraint, follows from the commitment of Western countries to making most political choices democratically. Therefore, the normative conclusions of law and economics scholarship--its views as to whether a proposed law would be good or bad--are relevant to the selection of legal rules in all societies where legal rules are chosen by or are constrained to be consistent with the preferences of a society's citizens.

The positive aspect of the law and economics approach is concerned with what is called comparative institutional analysis. To understand what is meant by this, recall that different possible laws produce different states of affairs. The normative task is to rank these potential states; the positive task is to describe them. For example, consider the choice between a steeply progressive income tax and a proportional or flat tax. Some analysts claim that a steeply progressive tax has bad incentive effects. They mean by this that if the government takes most of the dollars earned by a person with a large income, that person will attempt to earn fewer dollars. In general, economists believe, people balance the disutility of work-the preference for leisure-against the utility derived from the

monies working yields; hence, if the same amount of work yields less money, because taxes have risen, people will "consume" more leisure. If a substantial number of people actually do act as economists suppose, a society that has a steeply progressive tax will have less total wealth then a society that has a flat tax, because people will work less hard in the former society. Decisionmakers who prefer a progressive tax because they think it is fair commonly also prefer not to have a society that is too poor. Such decisionmakers have to choose a level of progressivity that is both fair and not too costly in terms of wealth foregone, and they therefore should want to know just how particular tax rate structures would influence society's wealth. The positive aspect of law and economics scholarship attempts to answer questions such as this. Its task, in this illustration, is to predict the amount of social wealth that various tax rates would produce, so that decisionmakers choosing a tax code can better understand the effects of their actions.

The positive aspect of law and economics scholarship is neutral to legal decisions in a particular sense: the question what tax code to choose is a moral and political question, whose answer is not determined solely by the amount of wealth that any given code would yield. Therefore, determining how possible tax codes will affect social wealth does not answer the question which specific code a society should adopt. But the positive aspect of law and economics scholarship is relevant to the moral question, because decisionmakers concerned with tax fairness also care about how much wealth their societies possess.

The positive aspect of law and economics scholarship actually is just economic analysis simpliciter; the methodology is that of economics itself. The best way to show how lawyers can and do apply this methodology is to run through particular legal problems, which I will do shortly. Now, though, I want to make a particular point about the use of positive law and economics analysis. There is an important distinction between practicing and consuming law and economics. A practitioner actually uses the economic tools of price and game theory to describe the states of affairs that legal rules could or do produce. To describe these states accurately requires some formal knowledge of economics. For this reason, much of the good work in law and economics, though by no means all, is done by academics, who have the time and vocation to learn disciplines in addition to law. Judges and legislators may not be producers of original law and economics analysis, but they can be sophisticated consumers. They can use the results of positive research when choosing among legal rules. The role of a judge therefore is analogous to that of an impresario, who must choose musical programs for his audience and hire musicians to play. The impresario lacks the time, and perhaps the vocation, to compose music and to play it at a high level of excellence. But he must know a great deal about music to choose popular programs and good musicians. Judges should therefore regard scholars as players and composers and themselves as impresarios, whose job it is to choose the soundest scholarly products as aids in making the best "legal music". To choose wisely, judges must of course

know something about these scholarly products.

(2) Illustration One: Unconscionability

The unconscionability doctrine has received a great deal of attention from law and economics scholars in the United States, Canada and Germany. I shall first present the prevalent approach to unconscionability issues and then present a law and economic analysis of the same issues. The prevalent approach is followed today by most American courts; the law and economics approach is adopted by a majority of American academic scholars. There is, among American legal academics, an optimistic and a pessimistic attitude to this difference between the courts and the academy. The optimistic attitude, for which there is some evidence, holds that current judges will be persuaded to the new views. The pessimistic attitude, borrowing from work in the history of science, holds that new theories succeed not by converting adherents to the old theories but by capturing the minds of the next generation. The pessimistic view may well be true because today's American courts faithfully reflect the views concerning unconscionability of their teachers, the scholars of the previous generation. Thus the ideas I shall discuss today probably will be adopted by tomorrow's judges, just when tomorrow's academics are questioning them.

The prevalent approach to unconscionability is this:[7] A court has the power to declare a contract clause unenforceable on the ground of unconscionability. A contract clause cannot be

held unconscionable unless it is both substantively and procedurally defective. A substantive defect exists when a contract clause orders or permits a harsh or unfair outcome. For example, a warranty disclaimer is (thought to be) harsh or unfair if it enables a firm to sell defective products but does not require the firm to compensate consumers for the harms those defects cause. A security interest clause is similarly unfair if it authorizes a lender to take a consumer's household goods in the event of default. As a last example, a clause that allows a franchisor to cancel a franchise contract--shut up a gas station, for example--for any default by the franchisee in its contractual obligations is harsh or unfair. In general, a contract clause is substantively unconscionable, in the prevalent view, if it permits a consumer or small business person to bear large losses in the event that things do not work out as expected. On the other hand, these outcomes are the result of terms in contracts, and the principle of freedom of contract, to which most courts adhere, provides that people can agree to almost anything that does not hurt third parties, even though some of those things seem foolish when viewed after the fact. Thus substantive unconscionability alone will not make a clause or the whole contract unenforceable.

The concept of procedural unconscionability also is necessary in the prevalent view. A contract term is procedurally unconscionable if it is the product of a bargaining process that is defective; a defective process produces contract clauses to which the consumer (or weaker) side does not fully agree. The

procedural unconscionability concept then rests on a set of factual propositions which collectively imply that consumers have no choice but to contract on the unfavorable terms that firms choose. To begin, everyone knows that a firm can do without the business of any one consumer, but consumers need the products of firms, from food to cars to shelter, to survive. The consumer therefore has little bargaining power with which to influence a firm's decision respecting contract clauses; rather, the consumer must take what the firm chooses to provide. Firms are aware of each consumer's powerlessness, and exploit it by selling products or lending money on unfavorable contract terms that consumers cannot vary; no consumer could negotiate for a better warranty than any given seller provides, for example. Also, though products that consumers want sometimes are sold by more than one firm, the contracts that these firms offer are very similar to each other. This similarity in contract terms is evidence both that consumers have no choice--the deal is everywhere the same--and that "the market"--that is, competition among firms--cannot protect the consumer's interests. Competition is useless if it everywhere generates the same result. Further, much imperfect information exists in consumer markets. In consequence, consumers cannot fully understand the deals that firms propose and firms also exploit consumer ignorance by proposing--indeed, insisting upon--one sided deals that benefit only the firms. Just about all bargaining processes that consumers enter therefore are procedurally defective.

The prevalent view of unconscionability, in sum, claims that

few clauses in current consumer contracts are the product of bargains between parties of equal power and knowledge. Therefore, many contract clauses are presumptively suspect--that is, procedurally unconscionable. When some of these clauses, such as warranty disclaimers, also seem harsh or unfair, the courts will not enforce them. According to the prevalent view, firms will use fair contracts only if the courts bar unfair contracts. A vigorously enforced unconscionability doctrine thus will much increase the quantum of justice present in market transactions. In conclusion, courts are faithful to their highest traditions when they police the conscionability of contracts between large aggregations of economic power and consumers or small business people.

The law and economics approach to unconscionability, in contrast, holds that most judicial actions taken in the name of unconscionability have been either useless, helping no one, or pernicious, increasing the cost of consumer transactions while simultaneously worsening the consumer's lot. Judicial unconscionability doctrine, this view claims, may be the paradigm example of the proverb that the road to hell is paved with good intentions. Law and economics scholars believe this unfortunate result to be the product of two factors: first, a virtual innocence on the part of many judges as to how markets actually function; and second, a lack of clarity about the appropriate moral criteria by which to assess the justice of contract terms.

An illustration is helpful in exhibiting the law and economics approach to the issue of contractual fairness.

Consider a consumer who wants to purchase a television set. The consumer, suppose, can understand the contract a firm may use, in the sense that if the firm disclaims warranties, the consumer both knows this and that he bears risks as a consequence. The firm initially offers a contract that obligates it to repair the television set if defects appear within one year of purchase; the contract shifts all other risks to the consumer. Thus, if the set explodes or burns, causing damage to the consumer or his property, the firm will pay nothing. The firm, however, would warrant against such losses were the consumer to pay it an additional $100. The consumer's choice is between spending $100 for "insurance" against personal injury or property damage or using the $100 to satisfy other desires. Now suppose the illustrative firm's customers generally prefer not to purchase insurance, so the contract is as initially offered. One such television set does burn, causing substantial damage to a consumer's house, and the consumer sues, despite the contract. A court could declare the clause excluding liability for these consequential damages unconscionable or enforce this clause.

The law and economics approach initially implies, on these facts, that the clause excluding the consumer's damage recovery should be enforced. The court's choice is to take an action--enforce the contract--that will produce a state of affairs in which firms are free to exclude consequential damage recoveries by contract, or it can take an action--ban the use of such clauses--that will produce a state of affairs in which future consumers necessarily must purchase insurance against

consequential harm, at a price of $100. The former state of affairs is better than the latter, according to this analysis, because consumers prefer the former state; they would rather spend $100 on clothes than on warranty protection. Therefore, to refuse to enforce the contract on grounds of unconscionability is to adopt a bad rule--that is, to take a bad action--, if the goodness of rules is assessed by the preferences of affected persons.

Considering the several objections to this analysis that are commonly made is illuminating. First, one may claim that the firm in our illustration would not offer consumers a choice between more or less warranty protection, but would instead force consumers to take less. The illustration, to be sure, is artificial because it supposes only one firm to offer televisions. To make the illustration more realistic, let several sellers exist, and assume that consumers actually prefer the more extensive warranty coverage against property damage or personal injury; they would pay the $100 for insurance if given a choice. Now suppose the first firm, called here F_1, refuses to offer coverage or offers it at an excessive price--$200. Then the other firms in the market could take much of F_1's business away by offering the same product with the warranty coverage consumers do prefer at a lower price. But if other firms will do this, F_1 will offer the warranty at a fair price too. Thus, the existence of other firms, of a market, protects consumers by creating incentives for each firm to identify and satisfy consumer preferences. This is why the illustration above

supposed that the firm would offer its customers a choice of warranty coverage.

Introducing the contribution that actual markets can make to consumer protection teaches several lessons. To perceive them, consider this example: all firms in a market offer the same warranty, which may be extensive or slight. This similarity in warranty coverage would be pernicious if the firms actually are forcing unwanted contract clauses on consumers, but it would be beneficial if consumers prefer the warranty that all firms offer, and every firm offers it because not to do so would produce a loss of business. The first lesson, then, is this: Nothing relevant to a court's decision whether to enforce a contract can be inferred just from a similarity of contract terms across firms. The issue is whether this similarity is the product of exploitation by firms or the yielding by firms to competitive pressure.[8] The second lesson is that the crucial datum for deciding whether to enforce is whether the market in which the relevant consumer purchased functioned well or poorly. If the market functioned well, it supplied the contract clause that the consumers in it most preferred. Then, a court should not ban that clause or any other the firms used: to strike clauses that consumers actually want is to create less preferred states of affairs. This analysis shows, therefore, that the prevalent approach to unconscionability issues, described initially, makes two fundamental errors: First, it infers that consumers are exploited when all firms use the same contract clauses; and second, it ignores the contribution that competitive markets can

make towards helping consumers. The second error causes adherents to the prevalent approach not to ask the right question, which is whether consumer markets function well or poorly.

The third lesson that law and economics analysis teaches concerns the appropriate legal responses to factors that can cause markets to function badly. Several causes of "market failure" may exist but for our purposes it will be useful now to discuss three: first, the existence of high shopping costs; second, the failure by some consumers to read contracts; and third, possible collusion among firms. Respecting the first, the claim that competitive pressure will force firms to satisfy consumer preferences presupposes a particular pattern of consumer behavior. Recall from the illustration above that if firm F_1 offered a less favored warranty, other firms would take business away from F_1 by offering better warranties. This process would occur only if consumers were aware of the warranty practices of firms, and would choose among firms on the basis of the coverage these firms offered. But it is costly for consumers to shop for warranty coverage because shopping takes time and also because actual monies sometimes must be laid out. Some consumers may consider the costs to them of shopping for warranty coverage to exceed the gains. Thus, they will buy from firm F_1, if they visit it first, regardless of the warranty that F_1 offers. If enough consumers act in this fashion, other firms will not compete to take away F_1's business by offering better terms; offering these better warranties would yield such firms no

increase in customers because consumers do not shop. A popular way to put this point is that the lack of shopping by consumers enables firms to act like monopolists. A monopolist sells to people who have little choice but to take the monopolist's product. If high shopping costs prevent consumers from shopping, they then have little choice but to take the contract that F_1, or any other firm, supplies.

The third lesson law and economics analysis teaches is that even when such market imperfections exist, banning contract clauses is not necessarily the best legal response. To see why, suppose firms that sell to consumers have monopoly power because consumers shop insufficiently. Such monopoly power can be exerted in either of two ways. First, a monopolist can supply to consumers the products and contracts that consumers actually prefer, but charge excessive prices--monopoly prices--for those products and contracts. Second, a monopolist may charge lower prices but force on consumers unwanted contract clauses or product attributes. Now a monopolist will choose that action that is best for it, but its likely choice is of crucial significance to the unconscionability debate. For if firms respond to the possession of monopoly power by supplying preferred contract clauses at excessive prices, a court should enforce these clauses for reasons we already know: to refuse enforcement would cause firms to supply even <u>less preferred</u> clauses or charge even <u>higher</u> prices, thereby producing worse states of affairs, as measured by consumer preferences. Recent economic analysis shows that the likely response of firms to the

possession of monopoly power caused by insufficient consumer shopping actually is to raise prices for products and their associated contracts rather than to supply unwanted contract clauses. In brief, firms do better by supplying products or contract terms for which consumers' willingness to pay is highest because firms then reach their breakeven points at lower levels of output.[9] Hence, even firms with market power arising from high search costs will satisfy consumer preferences unless the cost of doing so is high enough to dominate the demand affect just described. No reason exists to believe that the cost of supplying insurance against product related defects, which is the function warranties serve, is this high.

The third lesson, then, is this: that a market works badly does not imply that courts should refuse enforcement to the contract clauses that firms in the market use. Rather, the task is to see whether firms respond to the existence of market imperfections by using unwanted contract terms or by charging excessive prices. Often, firms will respond in the latter fashion. The prevalent approach to unconscionability thus errs in a third way because this approach enjoins courts to refuse enforcement to contract clauses whenever markets work badly. The result of committing this error is the doing of considerable harm to consumers.

The fourth lesson of law and economics analysis is that some social problems are better left to other legal institutions than courts. That firms respond to the possession of monopoly power by charging excessive prices is a social evil that should be

remedied. To the extent that monopoly power exists because high shopping costs prevent consumers from engaging in sufficient shopping, monopoly power can be reduced by lowering these shopping costs; then consumers will shop more.

In the United States, for instance, several methods for reducing consumer shopping costs, that do not use courts, have been used and proposed. I shall give two illustrations. Initially, the language in which firms quote prices and contract terms could be standardized; that is, contract clauses that accomplish the same ends should be set out in the same language, by any firm that wants to pursue these ends. Then consumers could more easily compare the contracts of different firms. Several American statutes, such as the Truth in Lending Law, require such contract standardization. Further, consumers could be provided with lists of the prices all firms in a market charge, so the consumers can conveniently learn which firms charge the lowest prices. Consumers are likely to shop at the low price firms when they can easily learn which firms these are, and this conduct should force the high price firms to lower prices. No American statutes now provide for the provision of price information to consumers in this way. Extensive experiments with the practice, however, both in Canada and the United States, reveal that providing consumers with price information significantly reduces the prices that firms charge.[10] Consumers do use the information to shop at low price stores, so that high price stores lower their prices in consequence. Thus providing consumers with price information on

a broad scale is a reform that should be tried. The fourth lesson, then, is that some market imperfections are best remedied by legislative or administrative interventions, not judicial ones. The law and economics approach does not claim that markets always function to benefit consumers, but rather, as this illustration shows, helps focus attention on those policy responses that are most likely to improve market performance.

The last two market imperfections mentioned above, that not enough consumers read contracts and that firms may collude, can be dealt with more quickly in light of the foregoing analysis. Although firms may take advantage of a lack of reading by consumers to impose unwanted contract clauses, their ability to do this is limited by the economics of mass transactions. Firms that sell in volume to consumers cannot know which individuals read contracts or shop for favorable terms. Rather, firms know only that some terms may generate more business than other terms. Firms thus offer contracts to the undifferentiated mass of consumers: if enough consumers in this mass will eschew unfavorable terms and purchase favorable ones, the terms that firms do offer will reflect consumer wants. Thus, consumers who do not read may be protected by the existence of consumers who do.

Further, the preferred solution to this problem, from a law and economics point of view, it to encourage consumers to read, for then the contract clauses that will be in use will be those that people choose rather than those that regulators choose for people. Two related ways to encourage reading are to require

consumer contracts to be set out in readily understandable language and to require contract language to appear in standardized form. The latter response encourages reading because a consumer who learns what the standard words say in connection with making a particular purchase will then be able to use this knowledge conveniently when making future purchases. Requiring contracts to be readable and standardizing contract language are frequent legislative responses to the reading problem.[11] To be sure, courts can make a constructive contribution by refusing to enforce clauses that are written in language that the ordinary person is unlikely to understand. But such selective, episodic interventions, though helpful, are not as efficaceous as the legislative interventions that law and economics proponents urge.

Finally, for two reasons courts should not be concerned with the problem of collusion among firms when the courts are deciding cases involving the enforceability of contracts. First, firms collude to obtain monopoly power; as we have seen, monopoly power is most frequently exercised by raising prices rather than by supplying inferior contract terms. Second, the antimonopoly laws, as enforced by public prosecutors, are a much better vehicle for the attack on monopoly power than the odd refusal by a court to enforce a particular contract clause that a monopolist uses. Monopolists, like the legendary monster, will grow new limbs if the existing ones are chopped off; hence, if one evil contract clause is barred, a firm with monopoly power will use another. The best way to deal with the monopoly power that

arises from collusion is to outlaw the collusion itself and enforce the prohibition with strong sanctions. This response, of course, is often made.

The law and economics approach to unconscionability issues, unlike the prevalent approach, therefore holds that courts seldom should refuse enforcement to contracts on such grounds as unequal bargaining power or substantive unfairness. Firms that supply consumer contracts generally do better for themselves when they offer the contracts that people prefer, perhaps at excessive prices, than when they offer unwanted clauses. Judicial refusals to enforce the clauses that firms do use, such as warranty disclaimers or exclusions of liability for consequential damages, thus create inferior states of affairs, if states of affairs are to be assessed by the criterion of people's preferences. Further, the prevalent approach wrongly implies that courts can make a broadly successful attack on the undesirable exercise of economic power by firms, and thus diverts attention from truly helpful social responses to this problem. In fact, courts are much inferior to legislatures and administrative agencies in responding to the evils of unchecked economic power. The law and economics approach makes this inferiority manifest, and also provides useful suggestions for appropriate legislative and administrative remedies.

(3) Illustration Two: Liability For "Mental" Losses

The prevalent approach to unconscionability has been

influential in the creation of the strict liability in tort doctrine. This doctrine bans exculpatory clauses that would shift to consumers the risk of incurring personal injury losses from defective products.[12] The prevalent approach unsurprisingly justifies this doctrine procedurally on the ground that imperfect information exists. In particular, it was argued above that markets would provide consumers with the warranties they want; the prevalent approach to strict liability in tort claims that consumers will want too little warranty coverage. This claim rests on three assumptions: (1) consumers prefer firms to compensate them fully for all harms, pecuniary and "mental" - i.e. pain and suffering losses - that defective products could cause; (2) consumers cannot calculate the risks of the harms to which they are exposed, because consumers have no expertise; (3) uninformed consumers believe that products are much safer than they are in fact, and so the "coverage" against harm that consumers believe themselves to want is less than full. These assumptions imply that warranty coverage will be too narrow because consumers will reject broader but more expensive warranties; also, firms will have insufficient incentives to produce safe products. Consequently, the law should require firms to bear all risks of harm from defects.

A law and economics analysis of strict liability quickly exposes difficult questions. For example, why is imposing risks on firms a better solution to this imperfect information problem than disclosure of data respecting risks? Why assume that uninformed consumers underestimate risk rather than overestimate

it? If consumers believe products to be less safe than they are in fact, firms could increase sales by dissipating this false impression. Is the substantial amount of information about product use and safety that firms now voluntarily provide a response to consumer pessimism? I will not pursue these difficult questions here but rather briefly focus on an important aspect of the first assumption above, that consumers want "full" warranty coverage against all product related harms. This assumption is questionable respecting harms manifested as pain and suffering or emotional distress; and as these harms make up about forty percent of the now very large typical products liability judgment, impeaching this assumption is significant.

A law and economics approach to the problem of "mental" losses begins with the observation that any liability that the law imposes on firms will be reflected in product prices; thus, as said above, the strict liability rule requires consumers to purchase insurance against risks by imposing these risks on firms. The law and economics analyst then evaluates strict liability by asking whether well informed consumers would want to purchase as much insurance as the liability rule requires. Persons insure to equalize their marginal utility of wealth in all possible states of the world they may face. An accident could increase the marginal utility of wealth by, for example, creating a need for medical care; the injured person will derive more utility from spending marginal dollars on doctors than on spending those same dollars on golfing fees were he uninjured. Thus the consumer will want to shift marginal dollars from the

state of the world in which he isn't injured to the state in which he is (until further shifts would no longer increase marginal utility). Wealth is shifted between possible social states by insurance, which sacrifices wealth in uninjured states, by paying premiums, to receive wealth in injured states, when the marginal utility for it is higher. Therefore, consumers will want to insure only against events whose occurrence would materially increase their marginal utility for wealth. The insurance that strict liability requires covers more than these events.

Accidents that create needs for medical care and shelter or that cause wage losses will increase persons' marginal utilities, but the issue here is mental losses -- pain and suffering and emotional distress. Losses of this kind do not directly increase a person's need for money; one who suffers pain does not need to buy anything, in addition to necessary medicine, in response. Mental losses thus could influence a person's marginal utility for wealth only if most people would want to make expenditures not only to treat the pain but to assuage it: Mr. Jones hurts and so will go to Tahiti as a recompense, or buy a new suit, or buy the car he always wanted. If people would sacrifice a substantial amount of current wealth, in the form of insurance premiums, so that they could materially alter their consumption patterns--buy South Seas vacations--in the event accidents cause them to suffer, than the "insurance" against mental harms that the strict liability rule requires people to purchase is justifiable; it would give people the dollars their better

informed selves would want to soothe pain. But to say that people would insure so they could buy fast cars were they injured seems farfetched, and there is almost no evidence that people actually do want this form of insurance. Also, because mental losses are hard for firms to predict ex ante and easy for consumers to exaggerate ex post, the price for such insurance would be very high. Strict liability for mental harms therefore is difficult to justify.[13] It produces a state of affairs--required insurance--that very probably is preferred less than no insurance by involved persons--the consumers. This result holds even if consumers are assumed to underestimate risk, for such risk underestimates would not cause consumers to eschew insurance coverage against mental harms; well informed people would not insure against these harms either because the harms do not substantially affect persons' marginal utility of wealth.

(4) Conclusion

The normative aspect of law and economics analysis holds that authoritative decisionmakers should rank possible states of affairs according to the criterion of people's preferences, and then choose from the set of possible legal rules those rules that generate the most preferred states of affairs. The positive aspect of law and economics scholarship assists decisionmakers in choosing such legal rules by describing the states of affairs that each rule in the set of possible rules would produce. Our discussions of unconscionability and strict liability used the

positive aspect of law and economics analysis to show that firms are likely to supply consumers with preferred contract clauses and that consumers sometimes prefer different contract clauses than courts commonly suppose them to want. Then the normative aspect implied the undesirability of legal rules, such as the judicially developed unconscionability doctrine and full strict liability, that ban or require contract clauses that consumers prefer or dislike. These rules are undesirable because firms respond to them by shifting to contract clauses that are less preferred by consumers. A vigorous unconscionability doctrine and the related strict liability rule, in short, produce bad states of affairs. Both the positive and the normative aspect of law and economics analysis show the general superiority of legislative and administrative responses to the evils to which markets sometimes subject consumers.

I conclude with the claim that law and economics analysis should be attractive to anyone who considers people's wants to be relevant to the choice of legal rules and who is interested in understanding the actual effects that legal rules produce. The number of people who fit this description is large; the partisans of law and economics are less numerous. My hope is that this paper will help equalize the size of these two groups.

Footnotes

* William K. Townsend Professor of Law, Yale Law School. Stephen J. Morse made helpful comments on a prior draft. A recent thoughtful paper with the same explanatory objective as this paper but which uses different illustrations is Richard A. Posner, The Law and Economics Movement, 77 American Economic Review 1 (1987).

[1] The seminal early work was Walter Blum and Harry Kalvin, The Uneasy Case for Progressive Taxation, 19 U. Chi. Law Review 417 (1952).

[2] See Joseph Bankman and Thomas Griffith, Social Welfare and the Rate Structure: A New Look At Progressive Taxation, 76 Cal. Law Review (January 1988).

[3] A good example of this work is Phillip Areeda and Donald Turner, Antitrust Law (vols. I-III 1978; vols. IV-V 1980).

[4] Calabresi published a series of papers throughout the 1960s; these papers are collected and expanded in his famous book The Costs of Accidents (1970).

[5] See Walter Blum and Harry Kalvin, Public Law Perspectives On A Private Law Problem - Auto Compensation Plans (1964).

[6] The law and economics approach is also congenial to Kantians and natural rights theorists. Both of these moral views hold that persons have the right to make enforceable contracts and otherwise pursue their economic interests. Since people obviously will be motivated by their preferences over states of affairs when engaging in these activities, allowing them the freedom to act necessarily implies respecting their preferences. Therefore, utilitarian, Kantian and natural law approaches commonly will yield the same policy prescriptions.

[7] A good statement of the prevalent approach in American and Continental Law is in Arthur von Mehren, International Encyclopedia of Comparative Law, Volume VII (Contracts In General), Chapter 1: A General View of Contract (1981). For a critical analysis of this Chapter see Alan Schwartz, Review, 31 The American Journal of Comparative Law 742 (1983).

[8] By the same logic, an analyst cannot infer anything conclusive from observing a single market price. This would be the monopoly price were firms able to collude or were consumers not to engage in searching for low prices; otherwise, the single price would be the competitive price. As the text next states, the analyst must ascertain which set of market conditions actually obtains.

[9] A more extensive explanation of this argument is in Alan Schwartz and Louis L. Wilde, Imperfect Information In Markets For

Contract Terms: The Examples of Warranties And Security Interests, 69 Virginia Law Review 1387 (1983). See also, same authors, Product Quality and Imperfect Information, 52 Review of Economic Studies 251 (1985).

[10] These experiments show that when consumers are given such comparative price information market prices decline substantially and price dispersion decreases. See Vicki A. McCracken, Robert D. Boyton and Brian F. Blake, The Impact of Comparative Food Information on Consumers and Grocery Retailers: Some Preliminary Findings of a Field Experiment, 16 J. of Consumer Affairs 224 (1982); Devine and Marion, The Influence of Consumer Price Information on Retail Pricing and Consumer Behavior, 61 American J. of Agricultural Economics 228 (1979).

[11] American plain language laws are discussed in Ross, On Legalities and Linguistics: Plain Language Legislation, 30 Buffalo Law Review 317 (1981).

[12] The American law of products liability is thoughtfully described in James A. Henderson and Aaron D. Twerski, Products Liability: Problems and Process (1987).

[13] A more extensive statement of this position is found in Alan Schwartz, Products Liability Reform: A Theoretical Review, manuscript (1987).

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