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The Law and Economics of Norms

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SUMMARY

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INTRODUCTION: THE EVOLUTION OF NORMS WITHIN ECONOMICS AND LAW: WHY NORMS WERE IGNORED, AND WHY THEY MATTER UNDER REALISTIC MODELS OF BEHAVIOR IN WHICH NORMS EMERGE AS THE OUTCOME OF EXCHANGE TO REDUCE COSTS

Both law and economics largely ignored norms until the 1990s.[1] Norms remained the exclusive province of the social sciences.[2] For the purposes of this Article, norms include patterns of behavior, impulses, and spontaneous ordering initially enforceable by non-legal sanctions (i.e., they are initially non-adjudicable) and promulgated by private parties.[3]

Classical economics ignored norms for several reasons.[4] First, because economics used abstract models of behavior built on rational choice theory and the individual utility function,[5] it did not study how people actually behaved and ignored the frictions of real exchange as well as norms—the self-imposed constraints that parties use to reduce such frictions.[6] Second, economics was not concerned with how preferences developed—only that people had preferences that they would seek to maximize (not taking into account encounters with or interests in others)[7] in a

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1. Robert Ellickson's work on cattle farmers changed everything. He demonstrated the willingness and ability of a particular community to ignore the legal rules and to govern disputes in accordance with non-legal norms. *See* Robert E. Scott, *The Limits of Behavioral Theories of Law and Social Norms*, 86 VA. L. REV. 1603, 1603 n.1 (2000) ("Ellickson is generally credited with anticipating, if not creating, the field of law and social norms."). Of course, Stewart Macaulay made an earlier contribution in documenting that business norms, rather than law or contract, governed disputes between businessmen. Stewart Macaulay, *Non-contractual Relations in Business: A Preliminary Study,* 28 AM. SOC. REV. 55, 63 (1963); *see also* Robert W. Gordon, *Is the World of Contracting Relations One of Spontaneous Order or Pervasive State Action? Stewart Macaulay Scrambles the Public-Private Distinction*, *in* REVISITING THE CONTRACTS SCHOLARSHIP OF STEWART MACAULAY: ON THE EMPIRICAL AND THE LYRICAL 49, 68 (Jean Braucher et al. eds., 2013) (situating Macaulay's exploring the public aspects of the private world of business practices as a "post-Realist tradition of scrambling the public-private distinction").

2. *See generally* MAX WEBER, THE THEORY OF SOCIAL AND ECONOMIC ORGANIZATION (Talcott Parsons ed., A.M. Henderson & Talcott Parsons trans., Oxford Univ. Press 1947). *See also* Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. LEGAL STUD. 537, 542 (1998) ("Sociologists have long studied the creation, transmission, and enforcement of norms as well as the pairing of norms with social roles. The field of sociology, however, has not had much influence on the scholars in other disciplines who have recently become interested in norms.").

3. *See* Richard A. Posner & Eric B. Rasmusen, *Creating and Enforcing Norms, with Special Reference to Sanctions*, 19 INT'L REV. L. & ECON. 369, 369 (1999) (defining a norm as "a social rule that does not depend on government for either promulgation or enforcement," and noting that "[n]orms may be independent of laws . . . or may overlap them").

4. If classical economists took any interest in norms, it was to look at predictable regularities. *E.g.*, Richard H. McAdams & Eric B. Rasmusen, *Norms and the Law*, *in* 2 HANDBOOK OF LAW AND ECONOMICS 1573, 1576 (A. Mitchell Polinsky & Steven Shavell eds., 2007).

5. With respect to rational choice theory "[i]t is important to emphasize a particular point here. The behavioral assumptions that economists use do not imply that everybody's behavior is consistent with rational choice. But they do rest fundamentally on the assumption that competitive forces will see that those who behave in a rational manner, as described above, will survive, and those who do not will fail . . . ." DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 19 (1990).

6. *Id.* at 11. *See generally id.* at 11–13 (discussing the problems with classical economic theory and how economists have sought to solve these problems).

7. The new institutional economists seem to recognize that people made choices that took into account the effects on others that might "on the surface [have] appear[ed] to be altruistic and not consistent with individual wealth-maximization [but] turn[ed] out to be superior survival traits . . . ." *Id.* at

perfectly functioning market.[8] This model ignored that those with preferences might engage in a different type of exchange that results in non-adjudicable norms. In this exchange, one party decides on an approach to resolve what he seeks as a function of his own preferences and beliefs[9] in an encounter with the expected response of another.[10] This process results in a norm.[11] Because preferences, endowments, and beliefs exist in the brain—within associated neural assemblies—these matters are endogenous to it.[12] The ramifications of this recognition of a norm as the result of an exchange will be explored later. Because economics focused exclusively on markets, it ignored non-market means of organizing and cooperating.

Likewise, law ignored norms. In the centrist view of law formerly embraced by economists,[13] law derived from the command of the sovereign, and people obeyed law because of its coercive threat.[14] In this ideal world, law functioned well and without costs.[15] Therefore, neither economists nor legal scholars considered that the effectiveness of, need for, or content of laws might depend on the underlying embedded norms,[16] beliefs, or other supporting institutions,[17] and on the interactions between these institutions as norms change.[18]

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8. *See* ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 156 (1991) (discussing rational choice model's "failure to explain how people come to hold particular preferences").

9. This view contrasts with the narrow view of the classical economists who, through "the same rational choice lens that has proven tractable in studying the direct effects of legal rules[,] . . . continue to treat values, moral character, and preferences as exogenous . . . ." Scott, *supra* note 1, at 1604–05 (footnote omitted).

10. *See id.* (noting that an actor's own behavior may be influenced by the behavior of others, such as a neighbor shaming the actor for failing to follow a norm).

11. The brain's selection of the terms of how an encounter with another person will be resolved is endogenous since it occurs as a function of the brain's internal mechanisms. *See* Ernst Fehr and Antonio Rangel, *Neuroeconomic Foundations of Economic Choice—Recent Advances*, 25 J. ECON. PERSP. 3, 3 (2011) (exploring "actual computational and neurobiological processes behind human behavior").

12. Of course, an array of outside, or exogenous, influences could influence parties' preferences, endowments, and beliefs, making them endogenous. *See, e.g.*, *id.* at 1603–04 (noting that laws may empower citizens to use public ridicule as an enforcement technique, and that laws may well be internalized where a person self-enforces due to potential feelings of guilt).

13. *See* AVINASH K. DIXIT, LAWLESSNESS AND ECONOMICS: ALTERNATIVE MODES OF GOVERNANCE 3 (2004) (discussing the centrist view of law where "the state has a monopoly over the use of coercion").

14. As Professor Schauer explains, it was H.L.A. Hart who recognized that custom could have the status of law rather than only having meaning if adopted by the command of the sovereign (the canonical Austinian position). *See* Frederick Schauer, *The Jurisprudence of Custom*, 48 TEX. INT'L L.J. 523, 527 (2013) ("Hart challenged the centrality of sanctions to the idea of law, and thus challenged the bedrock of what had first been Bentham's, and then became Austin's, account of the very idea of legality."). Although Hart recognized custom as a legitimate source of law, legal scholars and economists are not concerned so much with concluding whether something is law or not but with why we care about norms apart from whether they are called law or not. *See, e.g.*, Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338, 341–42 (1997) (noting that while law and economics scholars recognize the usefulness of norms in addressing legal problems, there is no consensus on the meaning of the term).

15. The assumption of costless functioning of the legal system ran into contrary conclusions when "economics recognized the ubiquity and importance of information asymmetries and transaction costs." DIXIT, *supra* note 13, at 3.

16. Williamson includes "norms, customs, mores, traditions," and religion at the "top level . . . [of] social embeddedness." Oliver E. Williamson, *The New Institutional Economics: Taking Stock, Looking Ahead*, 38 J. ECON. LIT. 595, 596 (2000) [hereinafter *The New Institutional Economics*].

Despite early neglect, today both law and economics recognize the importance of norms.[19] Under the robust view of human behavior embraced by the new institutional economists,[20] norms are part of culture.[21] Norms must inform any methodology that studies behavior and incentives and takes account of how parties with preferences follow norms in choosing actions. Norms matter because they are implicit ways in which people devise solutions to the problems of cooperation, exchange, and maximizing welfare.[22] Law cannot foster successful markets and societies on its own since law depends on norms that motivate people to adhere to law.

The increased importance of norms embodies an alternative approach to rationality: ecological rationality.[23] Under this view, people evolve mechanisms for cooperation and exchange; these institutions include not only norms, but trust and beliefs, organizations, and networks.[24] They all influence choice and help parties deal with "the complexity and incompleteness of our information," matters that classical economics ignored.[25]

Using new institutional economics as a baseline, this Article considers norms as coordinating devices and one of several alternative strategies (sometimes complementary and sometimes not) that enable parties to get the most out of their resources and achieve their goals. The costs and benefits of norms versus other arrangements, including law, should be compared to determine the optimal mix of formal and informal arrangements.

The origin and function of norms—and the roles that law, private exchange, and norms perform—differ across settings.[26] There is no one role for the law to play in a society in which various norms also operate.[27] Norms "are not monolithic"[28] since

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17. *See id.* at 596–97 (discussing the existence and formation of informal institutions). Ignoring norms may lead to other analytical errors: It can "cause one to overstate the significance of law . . . ." McAdams & Rasmusen, *supra* note 4, at 1589.

18. *See The New Institutional Economics*, *supra* note 16, at 595–96 (discussing the ignorance of neo-classical economics towards institutions and later affirming the fact that "institutions do matter").

19. *See id.* at 596 (discussing how norms and institutions slowly change); Scott, *supra* note 1, at 1603–05 (demonstrating the influence changing laws can have on social norms); McAdams & Rasmusen, *supra* note 4, at 1588–90 (analyzing how "[e]conomic analysis of law needs to consider carefully how norms may govern behavior in the absence of law and how a new legal rule may . . . change . . . a norm").

20. This is meant to include all of the various subfields of new institutional economics, evolutionary economics, etc.

21. NORTH, *supra* note 5, at 42.

22. *See* Vernon L. Smith, *Constructivist and Ecological Rationality in Economics*, 93 AM. ECON. REV. 465, 471 (2003) ("There is a sense in which ecological systems, whether cultural or biological, must necessarily be, or are in the process of becoming rational: they serve the fitness needs of those who unintentionally created them through their interactions.").

23. *See id.* at 469–70 (explaining how ecology fits into the new approach of rationality); *id.* at 471 (exploring the difference between rational choice theory, which "represents an observed socioeconomic situation with an abstract interactive game tree," and an ecological approach, which focuses on the origin of the norms or behaviors); ELINOR OSTROM, UNDERSTANDING INSTITUTIONAL DIVERSITY 122 (2005) ("Norms change the internal value that participants place on an action or outcome in a situation . . . .").

24. *See* AVNER GREIF, INSTITUTIONS AND THE PATH TO THE MODERN ECONOMY: LESSONS FROM MEDIEVAL TRADE 14 (2006) (defining institutions as "beliefs, norms, or behavioral traits").

25. NORTH, *supra* note 5, at 23.

26. *See* GREIF, *supra* note 24, at 14 (noting "that institutions are not monolithic").

27. *Id.*

they are part of the mix of law, private arrangements (such as contracts and firms),[29] beliefs, organizations, and rules. All of these institutions exist in societies; some are adjudicable, and some are non-adjudicable.[30] Norms will differ depending on their particular origin, purpose, the context in which they operate, and other supporting institutions.[31]

The proper "division of labor between . . . norms" and the relative role that law should or can play is complex.[32] Factors that affect the balance include barriers to express contracting,[33] economic structure, strength of the state, strength of the norm, presence of organizations, communication mechanisms, efficiency of the norm, likelihood of externalities, and the robustness of informal sanctioning mechanisms.[34] Understanding the appropriate role of the law versus other institutions, in particular cases, also depends on understanding the purpose that the norm serves.

By purpose, this Article looks at norms as devices to solve the problems that come with all exchanges: the problems of measurement (What is the object's value?), of asymmetric information, of uncertainty, and of opportunism. Parties pursue their objectives and navigate these problems partly by creating and adhering to norms.[35] "[P]rivate objectives" end up "produc[ing] institutional solutions that turn out to be or evolve into socially efficient ones."[36]

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28. *Cf. id.* (discussing institutions as norms).

29. For an article that compares the benefits and costs of different ordering mechanisms including not only private ordering and public law but also vertically integrated firms, see generally Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328 (2004).

30. *See* Posner & Rasmusen, *supra* note 3, at 370–71 (explaining that norms can be enforced in a variety of ways, including: automatic sanctions, guilt, shame, informational sanctions, bilateral costly sanctions, and multilateral costly sanctions).

31. *See* GREIF, *supra* note 24, at 15 ("[I]nstitutions have different origins and serve different functions . . . and sometimes reflect forward-looking behavior in well-understood situations."); *id.* at 148 ("Because different legitimate authorities are likely to have different objectives and because societies differ in terms of their legitimate authorities, institutional development is likely to vary across societies.").

32. *See* Saul Levmore, *Norms as Supplements*, 86 VA. L. REV. 1989, 1989 (2000) (stating that "the coexistence of social practices and legal obligations raises a set of interesting questions . . . about the division of labor between laws and norms").

33. If parties cannot negotiate without great expense a contractual provision to secure their goals and protect against hazards in long-term trade, then other devices of a non-legal or law-supplied default rule may be needed. *See* Macaulay, *supra* note 1, at 63 ("[C]ontract and contract law are often thought unnecessary because there are many effective non-legal sanctions."); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 10 (1985) (explaining a study that supports the view that "contractual disputes and ambiguities are more often settled by private ordering than by appeal to the courts").

34. Posner and Rasmusen, *supra* note 3, at 380 (explaining that "[l]egal sanctions are also important because many people are impervious to informal sanctions").

35. *See* Eric Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697, 1711–13 (1996) [hereinafter *Inefficient Norms*] (identifying problems arising from information costs that can make norms inefficient); McAdams & Rasmusen, *supra* note 4, at 1595 (noting that one issue in selecting norms or laws is whether norms "are generally efficient or inefficient"); Posner & Rasmusen, *supra* note 3, at 380 (emphasizing the importance of laws when "sanctions for violating norms are . . . too weak"). *But see* Avery Katz, *Taking Private Ordering Seriously*, 144 U. PA. L. REV. 1745, 1751–52 (1996) (remarking on the limitations that affect state-set norms); Robert C. Ellickson, *Law and Economics Discovers Social Norms*, 27 J. LEGAL STUD. 537, 551 (1998) (discussing the importance of norms in areas, such as the Internet, where resistance to government regulation is strong); Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. CHI. L. REV. 601, 654–55 (2007) (explaining how tax avoidance and related financial risks depend on the strength of a given norm); Eric Posner, *The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action*, 63 U. CHI. L. REV. 133, 157–

Norms, private arrangements, and legal rules promote welfare maximization and achieve the "common ends of the parties."[37] Those ends include the effort to "mitigate *conflict* and realize *mutual gains*."[38] Formal and informal mechanisms are all available tools for ordering society; however, the means of enforcement differ (e.g., private versus state).[39]

Whenever an individual creates or adheres to a norm, an exchange takes place. If an individual's beliefs incline him to follow a norm in order to avoid a cost that would come with deviating from the norm (clearly it is in his self-interest to conform), then a norm is the outcome of an exchange. The exchange is the decision taken to resolve what an individual seeks as a function of his own preferences and beliefs in an encounter, taking account of the expected response of another (or nature). It results in a norm (when there is repeated expression of it in subsequent encounters between individuals and others) that embodies a statement to the community of what has been found satisfactory as a result of individuals making decisions in encounters with others.[40]

Norms are thus a subset of the larger set of exchanges. A norm is just like every other institution, including what we normally think of as "a trade" or an "exchange."[41] When competing self-interests affect parties, the parties will try to minimize their costs so that they get more of what they seek from others (e.g., goods or satisfactions of various kinds) at the lowest cost.[42] This Article posits that the preference for cost minimization is one of the core mechanisms that permanently resides in the brain, or—if not permanent—is extremely resistant to change.[43] Once

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58 (1996) (examining the case for deferring to norms or resorting to legal regulations when groups are involved).

36. NORTH, *supra* note 5, at 16. Of course the institutions are not always efficient. *Id.*

37. *See* Yoshinobu Zasu, *Sanctions by Social Norms and the Law: Substitutes or Complements?*, 36 J. LEGAL STUD. 379, 383 (2007) (explaining that "social norms of the community . . . are assumed to maximize community welfare"). Scholars have identified several purposes norms can serve. Norms, as institutional elements, can "reduce uncertainty." NORTH, *supra* note 5, at 6. Additionally, norms can increase efficiency and reduce transaction costs. *See* WILLIAMSON, *supra* note 33, at 17 (asserting that organizational innovations and developments in economic institutions have economized transaction costs).

38. *The New Institutional Economics*, *supra* note 16, at 599.

39. *See* NORTH, *supra* note 5, at 36, 54–60 (discussing the formal and informal constraints that shape "human interaction" and different enforcement structures); GREIF, *supra* note 24, at 8–9 (explaining both state-mandated and "institutions-as-rules" frameworks, which rely on force as well as a private order framework where "order prevails despite the lack of a third-party enforcer").

40. Robert C. Ellickson, *The Market for Social Norms*, 3 AM. L. & ECON. REV. 1, 2 (2001) (describing a norm as "the purposive actions of discrete individuals, especially those who are particularly suited to providing the new rule and those who are particularly eager to have it adopted"). North states, "The evidence we have with respect to ideologies, altruism, and self-imposed standards of conduct suggests that the trade-off between wealth and these other values is a negatively sloped function." NORTH, *supra* note 5, at 22.

41. A separate question arises as to whether other exchanges are legally enforceable or not. Norms in this context assume non-adjudicability, but parties may choose to make other exchanges (e.g., contracts) legally enforceable. *See* Macaulay, *supra* note 1, at 63 ("[C]ontract and contract law are often thought unnecessary because there are many effective non-legal sanctions."). Parties may even decide to make norms legally enforceable by incorporating their terms into a contract. *See* Posner & Rasmusen, *supra* note 3, at 381 ("A contract is a set of norms constructed by two parties.").

42. *See* WILLIAMSON, *supra* note 33, at 2 (describing "transaction cost economizing").

43. *See* Colin Camerer, George Lowenstein & Drazen Prelec, *Neuroeconomics: How Neuroscience Can Inform Economics*, 43 J. ECON. LIT. 9, 49 (2005) (illustrating a cost-minimization tool by discussing the brain reaction of reward for seeing someone identified as a cooperator).

conceptualized in this way, from the inside of the human brain, it is easy to understand how these exchanges function as institutional supports for navigating in society and minimizing costs while helping parties achieve their goals.

Part I develops a broad definition of norms. Since every deviation from a norm is a cost,[44] and compliance with such norms often furnishes a satisfaction,[45] such tradeoffs play a part in the cost-benefit analyses affecting behavior and choice. But other costs and benefits also come into play in an actor's determining what conduct to follow. In an expected encounter with an agent, if the principal is friends with the agent, the principal may have as an object of choice a desire to maintain a friendship with the agent. Then a principal might value a possible stream of revenue resulting from maintaining a friendship with the agent. On the other side, the principal would weigh the costs of divergence by the agent, and these would be associated with a brain-state value of such costs.[46] Cost-benefit analysis thus includes not only the costs of complying with a norm or convention, or deviating from such, but also the costs and benefits associated with certain actions (such as hiring a particular agent). Part II discusses the origins of norms within genetics, social evolution, and culture. Part III explores how the economic view of norms has shifted from a centrist view, which segregated norms from law and economics, to a more robust theory of human behavior and motivation, which reintegrated norms into both legal and economic analysis. Part IV proposes a typology of norms distinguishing between (1) norms that have non-governmental origins and (2) norms that arise as the product of governmental intervention in market and social contexts. They are distinct but related since it is the presence of social norms and beliefs that either allows the parties to cooperate without the law or to cooperate in the face of the law. Part IV also identifies norms with non-governmental origins that operate as self-enforcing institutions that do not need government. Part V examines norms that are inputs and become incorporated into law,[47] with law sometimes completely displacing or substituting for the norm. Part VI looks at how law can generate substantive and enforcement norms where they do not preexist. This section also discusses how and why laws might be passed to change or destroy existing norms.

This Article looks at both types of norms (i.e., inputs to law and products of law) in terms of the functions they serve in solving problems and explores whether, when, and how norms, law, and private arrangements exist alone or interact with each other. Furthermore, this Article examines the evolution of which particular mix of formal and informal institutions dominates at a certain time. In contrast to other treatments of norms, which focus primarily on answering whether law or norms will optimize welfare, this Article emphasizes that parties trying to minimize the cost of exchange have the option of solving problems by private arrangements (e.g., contractual or firm) or through operating by informal norms. Thus, the decision of whether law can optimize welfare[48] depends on a comparison of the costs and achievability of contractual solutions and non-market solutions.

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44. *See* Scott, *supra* note 1, at 1610–11 (detailing the costs for violating norms).

45. *See* Ellickson, *supra* note 40, at 3 ("[S]omeone who honors a norm may reap informal rewards such as enhanced esteem and greater future opportunities for beneficial exchanges . . . .").

46. *See generally* Camerer, Lowenstein & Prelec, *supra* note 43.

47. Sometimes it is difficult to tell which originated first, the norm or the law since there are interactive effects. *See* Zasu, *supra* note 37, at 379 ("Both social norms and law are older than political society . . . .").

48. A similar trend away from a law versus norm or law versus market approach characterizes the

I. NORMS DEFINED: NON-ADJUDICABLE INSTITUTIONS ADOPTED TO RESOLVE PREFERENCES IN ENCOUNTERS WITH OTHERS: TOWARDS COST MINIMIZATION

As noted earlier, a working definition of norms would include patterns of behavior, impulses, and spontaneous ordering enforceable by non-legal sanctions.[49] The term "norm" is sometimes, but not always, interchangeable with "custom," "understanding," "convention," "arrangement," "agreement," "implicit contracting," "exchange," "institution," and even "constitution." (We could even throw in words like "tradition," "observance," "habit," "usage," "give-and-take," "protocol," "manners," "etiquette," "good (bad) form," "virtue," and "best practices."[50])

Failing to note these differences in usage can confound the discourse. For example, the interchangeable terms are often used without assuming enforceability by a governmental adjudicator or, sometimes, even by a nongovernmental third party adjudicator (say, a voluntary self-regulatory body), formal or informal.[51] Indeed, the terms often are principally meant to convey that very attribute; namely, a kind of voluntary observance[52] without the threat of positive intervention, but with propagation, perpetuation, modulation, and decay that depend on the dynamics (perhaps quite intricate) that lead to repeated acknowledgement by adherents through action.[53] Moreover, these rules are often unspoken (unless inquired about), let alone written.[54]

In this Article, such norms (and interchangeable terms) are dubbed self-sustaining or non-governmentally-adjudicable. Thus, even though people may follow norms for different reasons (such as social sanctions, fear, or inner compunction), what makes norms significant is that they help us make decisions.[55] Norms embody the belief systems that govern behavior.

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scholarship of Elinor Ostrom. "Contemporary research on the outcomes of diverse institutional arrangements for governing common-pool resources (CPRs) and public goods at multiple scales builds on classical economic theory while developing a new theory to explain phenomena that do not fit in a dichotomous world of 'the market' and 'the state.'" Elinor Ostrom, *Beyond Markets and States: Polycentric Governance of Complex Economic Systems*, 100 AM. ECON. REV. 641, 641 (2010).

49. Posner & Rasmusen, *supra* note 3, at 369.

50. Some have criticized the breadth of meanings attached to the term norm, arguing that such encompassing definitions become useless. *See* Scott, *supra* note 1, at 1607 (commenting on the connection between the absence of "even a basic consensus on the proper definition of a social norm" to the "complexity of the social phenomena that we are seeking to understand"). However, I am deliberately using a broad definition to emphasize the breadth of the underlying institutions, which support exchange and facilitate welfare in societies and promote economic growth.

51. *See* McAdams, *supra* note 14, at 340 ("Sometimes norms govern behavior irrespective of the legal rule . . . .").

52. *See id.* (defining norms as "informal social regularities that individuals feel obligated to follow because of an internalized sense of duty, because of a fear of external non-legal sanctions, or both").

53. *See* ELLICKSON, *supra* note 8, at 128 ("The best, and always sufficient, evidence that a rule is operative is the routine . . . administration of sanctions . . . upon people detected breaking the rule.") (footnote omitted).

54. *See id.* at 130 ("A rule can exist even though the people influenced by the rule are unable to articulate it in an aspirational statement . . . . Rural residents of Shasta County had trouble articulating the norms that governed how they shared the costs of boundary fences.").

55. As Greif points out, institutions, which include norms, "guide, enable, and constrain the actions of individuals." DIXIT, *supra* note 13, at 6 (quoting Greif).

This Article uses the term "norm" to broadly encompass "conventions." Some authors exclude conventions from norms on the theory that conventions (such as driving on the right side of the road) are followed due to self-interest and therefore lack any normative component.[56] We drive on the right side of the road to avoid being hit, not because we feel obligated to do so as a normative proposition. Without the normative obligation, the behavioral regularity would be simply an equilibrium that results when each person takes his best step considering the actions of others (e.g., to drive on one's right if the other party is driving on his right).[57] The driver has no conflict with the other driver; his only interest is to make sure that both parties coordinate their behavior.

This Article includes conventions in the norms discussion because both are part of the institutional substructure.[58] Conventions, like other institutions between people or between people and nature, involve an equilibrium state that comprises influences of various types, including everything that each side wants from the operation of the institution, making the resolution a kind of exchange.[59] Self-enforcement, while it works, results from a rational, stable equilibrium of a variety of the aforementioned influences.[60] So, to carve up the institutional universe into separate terms—based on different types of influences on the brain (i.e., those based on self-interest versus other influences, such as informal norms that exert a pull)—leads not to coherence but to piecemeal differentiation.[61]

An inclusive definition is useful for two reasons. First, by looking broadly at norms as including conventions, internal codes, and other influences on the brain—such as informal norms—one can fully understand how individuals maneuver in society with others.[62] There can be competing self-interests within one brain, and the brain resolves them (in a kind of exchange) by calculating which approach with which to deal with others or with nature, will minimize costs. Costs include not getting something of interest to an individual. These interests can include a good from another person or the satisfaction of complying with one's internal code.[63] In the case of a convention, the brain decides whether to comply with the convention or code or norm by considering the costs of deviance given the overall desire to minimize costs.

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56. Francesco Parisi distinguishes actions followed due to a normative obligation from "mere behavioural regularity." The latter are considered to "reflect mere behavioural patterns that are not essential to the legal order . . . ." Francesco Parisi, *Customary Law*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 572, 573 (Peter Newman ed., 1998); *see, e.g.*, McAdams & Rasmusen, *supra* note 4, at 1586–87 (choosing to exclude conventions from norms discussion).

57. Judge Richard A. Posner defines equilibrium thus: "[T]he point at which resources are being put to their most valuable use . . . ." RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 13 (8th ed. 2011).

58. "Each individual, responding to the institutional elements implied by others' behavior and expected behavior, behaves in a manner that contributes to enabling, guiding, and motivating others to behave in the manner that led to the institutional elements that generated the individual's behavior to begin with." GREIF, *supra* note 24, at 15–16.

59. *See id.* at 16 (arguing that institutions, like conventions, are "equilibrium phenomena" that respond to individual actors).

60. *Id.* at 15–16.

61. *See id.* at 13 (claiming there is a need to "integrate diverse lines of institutional analysis").

62. *See id.* at 14 (advancing that the departure from viewing institutions as "monolithic entities" and instead viewing them as "interrelated . . . rule, beliefs, and norms" allows one to see how they "enable, guide, and motivate" individual actors).

63. Since obeying norms or conventions or internal codes or religious convictions offers satisfactions, deviation from them is a cost.

Second, studying conventions allows one to fully analyze why and when legal intervention or other institutions might be needed even with behaviors that are self-enforcing.[64] For example, a norm works well, but it causes externalities such as harm outside the Mafia.[65] Conventions seem to be self-enforcing and so do other practices, such as signaling norms, because the best strategy (in terms of self-interest) is to follow the norms.[66]

Conventions and other self-enforcing norms should nonetheless be studied by those interested in optimal arrangements of non-adjudicable norms, adjudicable contracts, and law because sometimes, even with a self-enforcing system based on influences on the brain, there may be "exogenous shocks . . . that cause an institution to no longer be self-enforcing."[67] Moreover, there is no guarantee that the adherence to the norm will persist as individuals start to see benefits and costs of the exchange differently. People may no longer adhere to courteous driving as obeying the norm becomes too costly for those intent on pursuing other interests, such as using driving to signal how powerful one is. Those shocks and changes may explain why other institutions (formal or informal) develop to replace former self-enforcing institutions. Moreover, even with conventions like driving on the right side of the road, there may be a role for the law to play in providing a focal point or alerting new drivers to the content of the norm through publicity.[68] The least cost method might have the law pick the coordination point for actors who will then comply due to the satisfaction obtained from conforming to the norm (e.g., from not getting killed).[69] Finally, preferences, beliefs, and endowments of enough brains in the community may shift so that the norm is no longer cost-minimizing.[70] In this case, the norms may shift, but there may be a significant time lag.[71]

II. ORIGINS OF NORMS: NORMS AS SOLUTIONS OF THE COST MINIMIZATION FUNCTION: THE VIEW FROM INSIDE THE BRAIN

Norms originate in a basic genetic path forward that is programmed into our biology.[72] Many developed norms, those that survive over long periods of time, are

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64. *See id.* at 31 (proposing that "[t]o study the impact of the legal system" it is necessary to grasp the behavior enforcing institutions in which the legal system exists).

65. *See Inefficient Norms*, *supra* note 35, at 1722 (discussing criminal groups as an externality that might lead to inefficient norms).

66. *See id.* at 30 (claiming that these conventions "motivate, enable, and guide" individuals' behavior).

67. *Id.* at 16.

68. *See* Richard H. McAdams, *A Focal Point Theory of Expressive Law*, 86 VA. L. REV. 1649, 1666–68 (2000) (suggesting that "when the legal rule is sufficiently publicized," it can lend weight to a normative behavior).

69. *Id.* at 1668.

70. *See* DEIRDRE N. MCCLOSKEY, THE BOURGEOIS VIRTUES: ETHICS FOR AN AGE OF COMMERCE 4 (2006) (documenting changes in the populace that permitted an escape from "internal predation") (footnotes omitted). Preferences may shift so that a prior norm of accepting internal predation by kings or priests may no longer prevail as the preferences and beliefs of the members of the community shift so that they no longer view the loss of the old system's satisfactions as greater loss than the cost of continuing to forego prosperity.

71. *See Inefficient Norms*, *supra* note 35, at 1711 (discussing lag in norms).

72. KEN BINMORE, NATURAL JUSTICE 12 (2005). The argument for the survival of efficient norms depends on the idea of competition between societies. As Ken Binmore explains, the explanation as to

efficient and stable.[73] This is the evolutionary theory of norms, in which people begin to develop a sense of obligation as part of an "evolved outcome of a process similar to maximization."[74] If norms or patterns of behavior do not meet the basic criteria of efficiency and stability, they will be obliterated.[75] Efficient norms emerge without planning and develop through trial and error.[76] Societies with more successful norms will thrive and those with less successful norms will fail or have less economic success.[77] There is also evidence of a cultural gene that gyrates around, but not too far from, the ultimate genetic path forward.[78]

One theory, championed by Richard McAdams, to explain why behavioral regularities become norms rests on esteem.[79] Since all people desire esteem, once a regularity of behavior exists, people will conform to the behavior since they will gain more in esteem from conforming than from deviating.[80] The desire for esteem explains the adherence to a specific behavior resulting in a norm.[81]

The desire for esteem may offer an explanation for why third parties would undertake to sanction deviants. One might expect that parties would fail to sanction deviants because of a desire to free ride on others' enforcement efforts.[82] McAdams suggests that the free riding can be solved since sanctioning, in the sense of withholding or granting esteem, is costless.[83] Therefore, third parties may sanction deviants.

However, the esteem theory fails to explain why the precise norms that do persist are the ones that survive over time.[84] Therefore, it cannot explain the content of the norms since it does not explain why the particular regularity began. Resolving why a norm has a particular content, at least in the exchange context, requires an analysis of the functions of norms and other influences on the brain and behavior.

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why we should "expect evolution to succeed in selecting one of the efficient equilibria rather than one of the many inefficient alternatives" lies in "competition among groups." *Id.* at 12.

73. Of course, inefficient norms may sometimes arise. *See Inefficient Norms*, *supra* note 35, at 1698 (examining "plausible conditions [in which] . . . norms are likely to be inefficient, in the sense of failing to . . . exploit the full surplus of collective action") (footnote omitted); Paul G. Mahoney & Chris W. Sanchirico, *Competing Norms and Social Evolution: Is the Fittest Norm Efficient?*, 149 U. PA. L. REV. 2027, 2027–29 (arguing that "social evolutionary processes will tend to favor the adoption of efficient norms" in many areas of society).

74. McAdams & Rasmusen, *supra* note 4, at 1587.

75. BINMORE, *supra* note 72, at 12.

76. *See* Mahoney & Sanchirico, *supra* note 73, at 2030–31 (stating that in the leading theoretical approach to efficiency "norms are modeled as equilibrium strategy choices in a particular repeated game").

77. BINMORE, *supra* note 72, at 12. Where there are multiple efficient equilibria, fairness norms usually guide societies to select a fair option from among them. *Id.* at 14. Binmore provides a foundation for understanding and structuring the meaning of fairness around a Rawlsian consideration of the opposite side of the game. *Id.* at 15–16. It provides an understanding as to why one outcome from among many possible efficient equilibria is chosen. *Id.*

78. *See id.* at 61 (explaining how "[e]volution operates between successive plays of the game to increase the frequency of strategies in the population that get high payoffs at the expense of strategies that get low payoffs").

79. *See* McAdams, *supra* note 14, at 355.

80. *Id.* at 355–56.

81. *Id.* at 355.

82. *See* Scott, *supra* note 1, at 1608–09 (discussing effects of reactions to those holding different preferences).

83. *See* McAdams, *supra* note 14, at 364.

84. *Id.* at 394–97.

The main functions of norms and other comparable institutions are to reduce uncertainty and minimize transaction costs.[85] Norms develop as parties with different preferences interact with others while taking into account those others' reactions.[86]

The esteem theory addresses the origin of norms in the following way:

> For some behavior X in some population of individuals, a norm may arise if (1) there is a consensus about the positive or negative esteem worthiness of engaging in X (that is, either most individuals in the relevant population grant, or most withhold, esteem from those who engage in X); (2) there is some risk that others will detect whether one engages in X; and (3) the existence of this consensus and risk of detection is well-known within the relevant population. When these conditions exist, the desire for esteem necessarily creates costs of or benefits from engaging in X.[87]

The esteem theory helpfully emphasizes why parties would want to conform to a norm (more esteem) and why they would not deviate (more sanctioning) and the structural and informational conditions under which norms are likely to develop.[88] It explains why parties might avoid behaviors that result in disesteem (to avoid cost) and why parties might engage in behaviors that are preferred (to gain esteem).[89]

However, this framing perhaps too narrowly focuses the decision-making and choice solely in terms of the desire for esteem, or the desire to avoid disesteem, and the associated costs and benefits. Moreover, the model seems to be built on norms arising from an external factor: an existing norm and the desire for esteem. The esteem theory cannot explain behavior in the first instance—before the norm has been deemed to be the acceptable choice between multiple encounters between human beings and others.[90] Yet, in these early instances, when an individual is deciding what choice to make in an encounter with another, the result of that encounter is an exchange. To explain the choice being made, one needs a model that operates from the inside out rather than from the outside in. The choice that parties make that results in a norm is part of an exchange that involves several tradeoffs that are made in the brain, only some subset of which involves a cost or benefit associated with gaining or losing esteem.[91] When one party decides whether to follow a norm, that party starts with preferences, beliefs, and endowments that are endogenous to an individual with certain neural assemblies.[92] A party resolves what action to take in light of those preferences, as well as the expected response of others. Thus, the desire for esteem, which can be satisfied by following a norm, is only a part of the calculus that the individual goes through in arriving at a choice of action.[93]

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85. *See infra* Section IV.A.

86. *See Inefficient Norms*, *supra* note 35, at 1733–34 (discussing the "coordination game" and the "prisoner's dilemma").

87. McAdams, *supra* note 14, at 358 (footnotes omitted).

88. *Id.* at 355.

89. *Id.* at 355–57, 366–67.

90. *See id.* at 367 (discussing "the simple case where a norm arises *after* there is already a behavioral regularity consistent with the consensus" and then addressing the case where a new norm is created).

91. *See id.* at 370–72 (discussing the esteem aspect of norm creation).

92. *See supra* note 12 and accompanying text (discussing the interaction between endogenous and exogenous influences).

93. The fuller picture of exchange that is the central focus of this Article starts with parties' beliefs

Essentially, the party starts with objectives and has to decide between the cost of not achieving one good (i.e., an objective, purpose, or goal) against the cost of another good, and then come up with a rate of substitution at which he is willing to incur one cost to prevent the incurrence of the other cost. Esteem is one part of the cost calculus, but it is folded into the human decision-making process that also involves the comparison of how a decision will affect the achievement of different goals or goods simultaneously.[94]

The process by which the brain deals with preferences, beliefs, and endowments in a cost-minimizing way may also broaden our understanding of effects on human behavior in still another way. Robert Scott suggests that how norms affect behavior "can be analyzed in terms of changes in the costs and benefits of particular behaviors."[95] Parties' "opportunity set[s]"[96] change as parties gain information from the norm about the costs of taking or not taking certain behaviors.[97] Scott poses a rational choice analysis to determine the effects of norms on decision-making.[98] This Article agrees that the cost of deviating from or complying with norms will constitute one piece of information or outside influence that will be taken into account by a decision-maker who is weighing how to resolve an encounter with another. Expected criticism by others for one's failure to comply with a norm will be a part of the calculus, but the tradeoffs will include a whole array of outside influences as well as the preferences, endowments, beliefs, and a rate of substitution between competing influences.[99] Esteem theory offers a theory for how norms might change. It suggests that if there is criticism of a norm, that norm might change. This could occur as parties with a certain preference gain more information from critics of the norm, which helps to shift the norm.[100]

This Article suggests that the model is one that operates at the level of an individual making decisions in encounters with others. Those decisions will begin with beliefs, endowments, and preferences and they will involve tradeoffs in which a party with a goal (for example, perhaps the goal of being invited to a party and the desire to smoke freely wherever one goes) has to trade off that preference against the cost of another good (such as the esteem of others and the lack of party invitations). Taking into account the rate of substitution and a consideration of how willing an individual is to incur one cost to prevent the incurrence of another cost (e.g., being willing to incur the cost of not smoking in order to avoid not being invited

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and objectives and explains how choices are made in light of those beliefs and preferences given the expected reactions of others. One might have a strong preference to allow smoking at parties at one's home, and that preference might trump the expected reaction of others, including one's guests. One would trade off the possible loss of esteem from some guests, the possible increase in esteem from those that value smoking, and the loss of the possible objective of having a successful party if too many people stay away due to the smoking (or due to the ban on smoking).

94. *See* McAdams, *supra* note 14, at 355–57.

95. Scott, *supra* note 1, at 1618.

96. *Id.*

97. *See id.* at 1632 ("Thus, our putative moral defective observes that she loses opportunities because she cannot make credible commitments. The motivation to increase her opportunity set stimulates the necessary characterological changes in values. Out of this process emerges a 'new person.' New and better preferences and values—honesty, loyalty, trustworthiness—now form part of the individual's stock of traits.").

98. *Id.* at 1613–21.

99. *See id.* at 1612 (suggesting that "an embedded hierarchy of values" may be at work in resolving such conflicts).

100. McAdams, *supra* note 14, at 395.

to the party) gives a fuller picture of the decision-making going on among many individuals in society. The individual's preferences, beliefs, and endowments can be influenced by a variety of outside influences, including the possible reactions of others.[101] Those reactions in this model then influence the brain and change the brain so that these outside influences become endogenous to the decision-making.[102]

Therefore, this Article, while recognizing the enormous value of an esteem theory of norms, will emphasize the idea that norms originate as a resolution from exchanges that parties make to satisfy their preferences while taking into account the reaction of others and the desire to minimize the transaction costs and uncertainties that plague complex transactions.[103] This explanation for the origin of norms, based on a functional analysis of cost reduction, can help explain why particular substantive norms arise and why other institutions may be called for when the norms are no longer achieving their purposes.

If one seeks to understand why parties may adhere to a "no-smoking at a party norm," there is much to be learned from applying the web of overtures and responses (the trade paradigm). As an attendee, one might start with the objective of being at the party (an object of choice). One might also have a preference for smoking, but in resolving what action to take one would weigh the desire to be at the party against the possible denial of future invitations, the potential loss of future business partners, and the risk of being thrown out by the host as costs that may account for an individual bearing the cost of voluntarily adhering to a no-smoking norm. The host would engage in similar calculations, which may ultimately result in a no-smoking policy at parties in the household.

III. SEPARATION OF LAW AND NORMS: EVOLUTION OF NORMS WITHIN ECONOMICS AND LAW

The traditional disinterest in norms by economists and legal scholars meant that their theories did not attempt to explain the role of norms. Norms played no role in their theories because law was conceptualized as a top-down mechanism of formal laws that attained the goal of public order through coercive enforcement. Law was considered the only way to bring order and control violence.[104]

Economists applied their tools of the trade—primarily rational choice theory—to understand different substantive areas of law.[105] Economics succeeded at explaining how people with given preferences make choices and how goods or objects are moved by consensual exchange.[106] This model works particularly well at

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101. *See id.* at 355–56 ("[Evidence] shows that people pay for status goods to signal their wealth or 'good taste,' that people incur material costs to cooperate in situations where their only reward is the respect and admiration of their peers, and that individuals conform their behavior or judgment to the unanimous view of those around them in order to avoid the disesteem accorded 'deviants.'").

102. *Id.*

103. *Cf.* NORTH, *supra* note 5, at 6 (discussing institutions as a response to uncertainty).

104. *See* Ellickson, *supra* note 40, at 3–4 (describing the Hobbesian view that "people are unable to coordinate with one another without significant assistance from a coercive central authority").

105. *See* Scott, *supra* note 1, at 1604–05 (explaining that direct effects of legal rules can be understood through a "rational choice lens" that treats "values, moral character and preferences as exogenous" when "analytical tools" provide no guidance).

106. *See* Ellickson, *supra* note 40, at 13 (explaining norms as part of an exchange process).

illuminating the operation of financial markets.[107] Such economic theories, however, were built on unrealistic assumptions of frictionless exchange and perfect information.[108]

Economists assumed parties governed by idiosyncratic taste (e.g., preferences and endowments) could always improve welfare, both private and societal, by exchange in the market.[109] Economics did not care about the messiness of actual transactions; it ignored transaction costs and other impediments to parties that might impair the parties from realistically being able to achieve their goals.[110]

Because the theory of rational choice assumed away transaction costs and ignored how preferences developed, it remained indifferent to norm formation—to the idea that in pursuing individual preferences and beliefs, individuals, in an encounter with another's expected beliefs, would seek a resolution that would minimize costs. Because it presumed frictionless markets, economics ignored the role that norms, as institutional supports, could play in minimizing the costs of transacting and promoting exchange.[111] Economists neglected the importance of norms because they downplayed the "complexity and incompleteness of our information,"[112] and the institutional supports required to overcome those complexities if parties were going to actually maximize their gains from trade (at a reasonable cost). They did not see that norms could play a role in helping parties navigate complex environments and that parties would take into account the reactions of others to arrive at a satisfactory solution.

Likewise, law also downplayed the importance of norms, albeit for different reasons. Under the centrist model of law, law ignored norms and the complexities of people's motivations for obeying or disobeying laws.[113] As conceptualized, the content of law remained independent of norms and people obeyed the law because of the prospect of state punishment.[114] Legal centrists believed that the passage of a single law would affect human behavior and achieve its goals.[115] They failed to consider how underlying norms and informal constraints would affect goal achievement differently, even in countries with identical laws.[116]

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107. *Cf. id.* at 2 (providing an illustration of how the creation of norms, much like supply and demand, can be explained by rational choice theory).

108. NORTH, *supra* note 5, at 11.

109. *See* Scott, *supra* note 1, at 1613 n.22 (discussing the maximization of utility via choices based on preferences).

110. *See* NORTH, *supra* note 5, at 11 ("[Economic theory's] harmonious implications come from its assumptions about a frictionless exchange process in which property rights are perfectly and costlessly specified and information is likewise costless to acquire.").

111. *See id.* at 12 (describing how "difficult it is for economists to come to terms with the role of institutions in capturing the potential gains from trade").

112. *Id.* at 23.

113. *See* Robert D. Cooter, *Against Legal Centrism*, 81 CALIF. L. REV. 417, 417–18 (1993) (reviewing ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991)) ("[M]ost American scholars apparently regard the common law process as one in which judges make law, rather than finding it in social norms.").

114. *See* NORTH, *supra* note 5, at 21 (citing research pointing out that issues of free riding, fairness, and justice "enter the utility function" leading to "more elaborate models of human behavior").

115. *See* Cooter, *supra* note 113, at 428 (in contrast to law, "custom is not under anyone's control (it lacks 'secondary rules'), so it cannot be directed to serve the ends of policy makers.").

116. *See* NORTH, *supra* note 5, at 36–37 (describing the importance of informal constraints and how it is a "key to understanding a more complex behavioral pattern than is derived from the expected utility model").

Efforts to enact "contract, tax, and bankruptcy laws" in the Soviet Union demonstrated that laws may flounder if underlying norms and institutions do not support the formal constraints.[117] This is an example of how "[i]gnoring norms . . . can cause one to overstate the significance of law . . . ."[118]

Once economists, like Douglass C. North and Oliver Williamson, emphasized the limits on bounded rationality and the deficiency of rational choice theory's dismissal of transaction costs, other economists took a greater interest in all aspects of behavior that could increase or decrease the cost of exchange.[119] Williamson studied private governance structures devised by parties to lower the costs of exchange.[120] He assumed that the rules of law were fixed and that parties would structure their transactions and use either contracts or vertically integrated companies—non-market organization—depending on which method would minimize transaction costs and maximize surplus.[121] North looked at norms and other institutional constraints as a means to facilitate exchange and increase prosperity.[122] Norms—along with laws, beliefs, and organizations—became part of the equation for reducing the costs of exchange and increasing gains from trade.

Understanding norms and their functions and their influence on beliefs, in various settings, remains the first step to determining why particular norms develop, and how they evolve and change. Such knowledge will illuminate when law needs to intervene or when it can remain neutral, why and how to minimize the occasions to use coercive force, and how laws and norms influence each other. These institutions are connected since one cannot establish other structures of society—such as property rights, laws, constitutions, judiciary, contract, and the production function—without taking account of the embedded norms.[123]

Norms and law are related. They share a function in solving the problem of social order, deterring cheating, and making it possible for societies and economies to thrive. The better a society's institutions—including informal norms, beliefs, organizations, and formal laws—are at effecting these goals, the greater the overall welfare of the community.[124] Society requires cooperation and coordination in order to solve problems, create exchanges, and provide credible commitments. Norms, contracts, and law provide different ways of achieving those ends. They are all

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117. John M. Litwack, *Legality and Market Reform in Soviet-Type Economies*, J. ECON. PERSP., Fall 1991, at 77, 77–79.

118. McAdams & Rasmusen, *supra* note 4, at 1589.

119. For an example, see David Mamet's new book on costs of maneuvering without an understanding of norms and how much more costly interactions would be. DAVID MAMET, THE SECRET KNOWLEDGE: ON THE DISMANTLING OF AMERICAN CULTURE 13 (2011) (discussing the "tool of culture").

120. WILLIAMSON, *supra* note 33, at 68–84 (providing an overview of the factors that impact private governance structures and particular circumstances that present special difficulty).

121. This is Williamson's discriminating alignment thesis. *See id.* at 72–79, 90–95 (examining the concept of matching governance structures to transactions in an efficient way and discussing the discriminating alignment theory).

122. NORTH, *supra* note 5, at 5–10.

123. *See The New Institutional Economics*, *supra* note 16, at 596 (discussing how the first level of social analysis starts at the "social embeddedness level," which is where norms are located).

124. *See* NORTH, *supra* note 5, at 7 (asserting that institutions can be made a "determinant of economic performance," and "the persistence of inefficient institutions . . . was the result of . . . a disparity between private incentives and social welfare").

institutions and, as such, are the results of brain-driven cost-minimizing exchanges (i.e., trades).[125]

Norms sometimes thrive[126] and sometimes decay.[127] They sometimes operate where there are no states or strong legal courts for enforcement, and at other times they function in concert with legal rules.[128] At times, the norms are precursors for and sources of the later adopted legal rules.[129] Part VI examines this process of migration and incorporation. Occasionally, norms blossom in self-sustaining isolated societies without affecting larger norms in society or the laws and institutions that govern at a broader level.[130]

IV. OVERALL NATURE, FUNCTIONS, AND CAUSES OF NORMS AND OTHER INSTITUTIONS: A TYPOLOGY OF NORMS

A. Nature and Functions of Norms

Recognizing the complexities of human behavior, new institutional economics promotes a richer picture of how complex decision-making is and how difficult it is to bring order to society so that parties can efficiently engage in exchange.[131] The question then becomes how to operationalize our understanding of norms. The key lies in connecting the role that law should play, if any, in a world of already embedded norms, to the functions that the norms serve in different contexts and to the limitations that might hinder the creation or operation of norms. This Article suggests that once the functions of norms are understood, it becomes possible to understand how and why the law and norms divide their respective roles. Additionally, this understanding illuminates why the role of law or norms will need to shift in response to changes in either of them and how to best achieve that change.

Norms change, and law sometimes seeks to manipulate or accelerate that change through legislation or adjudication.[132] In other instances, norms are static and dysfunctional, and the role of the law shifts to overcoming the inertia of such

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125. However, these institutions may differ in terms of adjudicability (versus non-adjudicability).

126. *See* Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 U. VA. L. REV. 1781, 1788 (2000) (discussing how norms may reach different equilibria). Law itself would be ineffective if there were no norm of adhering to and following laws. The widespread tax evasion in Greece furnishes a current example of how the absence of informal norms of compliance can undermine the effectiveness of a formal rule. *See id.* at 1782–83 (discussing tax compliance in terms of underlying norms); James Kanter, *Task Force Urges Greece to Improve Tax Collection*, N.Y. TIMES, Nov. 18, 2011, at B2, *available at* http://www.nytimes.com/2011/11/18/business/global/european-commission-urges-greece-to-tighten-tax-collection.html (discussing tax evasion issues in Greece).

127. *See* Posner, *supra* note 126, at 1788 (noting that norms "may crumble").

128. *See id.* at 1791–92 (discussing the possible benefits of encouraging people "to act properly because of social norms, rather than because of fear of legal sanction," and noting the possibility that government can modify laws to "manipulate social norms . . . from the outside").

129. *See id.* at 1793 (stating that, in some cases, the government will outlaw an action only after "it has become a signal").

130. The persistence of such self-sustaining communities in modern times, which have strong states, is a puzzle that Richman addresses in his article. *See* Richman, *supra* note 29, at 2359–62 (discussing such self-sustaining sub-communities within close-knit communities and among Silicon Valley engineers).

131. Ostrom, *supra* note 48, at 641.

132. *See* Ellickson, *supra* note 40, at 39 (discussing the role of government as a "change agent").

embedded, "sticky" norms[133] (such as anti-dueling statutes or racial discrimination laws).[134] Change can also occur when "an institution cultivates the seeds of its own demise, leading to endogenous change."[135]

The best way to understand norms is not only to consider them as serving particularized functions (e.g., solving the driving coordination problem, or solving the principal-agent problem), but also as broader efforts to "find better solutions" to the circumstances that transactors face.[136] For example, based on observations in different settings, one can argue that human nature prompts people to find cost-effective solutions in encounters with others because "the economic livelihood of the appropriators depends on their ingenuity in solving individual and joint problems."[137] All norms thus serve as tools (one of many institutions) for better private ordering to manage resources and minimize the transaction costs of exchange. However, each norm may achieve those goals in different ways in particular contexts, depending in part on the costs of alternative arrangements—such as contracts—and adjudicative forms—such as common law, statute, and agency law—and the particular advantages and disadvantages of each solution in such contexts.[138] Thus, when studying norms, we must also analyze private exchanges (including contracts) and the law to see how they co-exist, interact, substitute for, and displace one another. Sometimes (1) norms supplement private contracts;[139] (2) law seeks to change a norm;[140] (3) law encourages the development of a norm;[141] (4) law refines the content of a norm; (5) law seeks to incorporate a norm as a source of law;[142] (6) law displaces a norm, as when the norm deteriorates or mishandles a conflict in norms or values;[143] (7) a norm softens the

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133. Dan M. Kahan, *Gentle Nudges vs. Hard Shoves: Solving the Sticky Norms Problem*, 67 U. CHI. L. REV. 607, 608–09 (2000).

134. *See infra* Section VI.C.

135. GREIF, *supra* note 24, at 17.

136. *See* Clayton P. Gillette, *Lock-In Effects in Law and Norms*, 78 B.U. L. REV. 813, 833–35 (1998) (discussing how social norm behavior creates solutions to the driving coordination problem).

137. ELINOR OSTROM, GOVERNING THE COMMONS: THE EVOLUTION OF INSTITUTIONS FOR COLLECTIVE ACTION 34 (1991).

138. Well formed norms may guide individual behavior similarly to laws, markets, and regulatory agencies. *See* McAdams & Rasmusen, *supra* note 4, at 1597–1608 (revealing the role of norms in tort law, contract law, and other areas of law).

139. *See* Scott, *supra* note 1, at 1632 ("Cooter's claim rests on the assumption that an individual's character is 'translucent'—at least to his intimates and close colleagues. While the state may not know whether an individual is a 'cooperator' or a 'defector,' basic moral values are observable, albeit imperfectly, by friends, neighbors, and coworkers. Knowing that, an individual with a defective moral character observes that she lacks the ability to solve ordinary commitment problems in the absence of formal mechanisms like enforceable contracts. Social interactions depend on credible commitments that are self-enforcing. Thus, our putative moral defective observes that she loses opportunities because she cannot make credible commitments. The motivation to increase her opportunity set stimulates the necessary characterological changes in values. Out of this process emerges a 'new person.' New and better preferences and values—honesty, loyalty, trustworthiness—now form part of the individual's stock of traits.").

140. *See id.* at 1622 ("The expressive effects of law are those consequences of legal rules that stimulate changes in social norms and conventions and/or change the social (or normative) meaning of particular behaviors.").

141. *See id.* at 1615 ("[B]y expressing the sentiment of the community, the ordinance modifies or stimulates the creation of an underlying norm in some way.").

142. *See id.* at 1614 ("[T]he effect of the law is to teach the community about the general local sentiment regarding the conflict between dogs and trees.").

143. *See id.* at 1624 ("[C]hanges in preferences and values occur because the social meaning of

effect of a rule or a law to provide flexibility;[144] (8) a norm displaces the need for any contract provision or law;[145] and (9) norms completely act as a private order without a need for law but with private contracts.[146] The driving force in exchanges or in the choice of institutions is whether the benefits exceed the cost. Which arrangement or group of arrangements (institutions, etc.) will minimize costs and achieve the parties' goals? Answering that question is sometimes a decision that parties will make when they decide to make a norm (to which they have been adhering) enforceable by including it in a contract that is adjudicable. In making that decision, individuals would consider the costs of non-compliance, even with the legal enforceability feature; the cost of judicial error; and the cost of opportunistic behavior if it is not controlled by norms through informal sanctioning.

The role that the norms play may change. In some instances, the norms that thrived in a personal setting may underperform in a larger, more impersonal exchange setting.[147] In other instances, the norms will persist but will evolve to take account of new technologies.[148] Understanding these aspects illuminates how parties choose to structure their relationships in order to minimize transaction costs and maximize overall value in varying environments. Norms sometimes combine with other institutional enforcement mechanisms, both legal and non-legal, and at other times remain hostile to legal enforcement. At the same time, understanding how law can piggyback onto or jump start norms, and how norm entrepreneurs[149] create and promote certain norms, can answer questions about the role that law will play in changing dysfunctional norms.

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littering or not cleaning up after one's dog has been changed from the exercise of free choice to a demonstration of disrespect for others. A 'norm cascade' is stimulated by the mere consequence of changing preferences and behavior in some citizens, and, at some point, the behavior reaches a tipping point and a new norm is entrenched."). Norms are agreements or contracts of a type, though they are not adjudicable unless they have been ensconced in an adjudicable form or announced by the court or legislature as such. *See* McAdams, *supra* note 14, at 350 ("[N]orms are enforced by some means other than legal sanctions. If recycling were a norm, for example, we would not mean that—or at least not merely mean that—the state punishes the failure to recycle but rather that the obligation to recycle is enforced by a nongovernmental sanction—as when individuals internalize the duty and feel guilt from failing to recycle or when individuals privately punish those who do not recycle.").

144. *See* Scott, *supra* note 1, at 1606 n.8 ("Along another dimension, the meaning of law is precise; the meaning of norms is fuzzy .... These differences imply that sometimes law and norms function antagonistically. See, for example, the code of silence among certain professional groups that undermines legal requirements that illegal activity be reported.") (citation omitted).

145. *See id.* ("[D]isfavored behavior constrained by norms may not require additional legal sanction.") (citation omitted).

146. *See* Ellickson, *supra* note 40, at 14 n.29 ("Business customs . . . are shaped not only by informal exchanges but also by explicit contracts.").

147. *See* McAdams, *supra* note 14, at 343 ("Within law and economics, Janet Landa and Robert Cooter sought to explain why, in parts of Asia, ethnic minorities tended to dominate the middleman position in many industries. They concluded that these 'ethnically homogenous middlemen groups' succeed in nations without reliable legal enforcement of contracts because the groups' social connectedness give their members a unique means of (informally) sanctioning contract breaches by other group members.") (footnotes omitted).

148. *See, e.g.*, Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 143 (1992) (discussing the diamond industry's shift towards new technologies).

149. Ellickson, *supra* note 40, at 15.

B. Typology: Norms That Are Inputs Versus Norms That Are Products of Governmental Intervention

Before examining particular norms, it is important to distinguish between norms that arise from a source other than the government but may become eligible as an input to a governmental intervention (i.e., an eligible input, or EI)[150] and norms that are the product of a governmental intervention.[151] The next two sections will deal with EIs. In these cases, the governmental decision to intervene (thereby making the norm a governmental rule) or not depends on a comparison of the cost of achieving desired goals through non-governmental actions (including norms and contracts) with the cost of the governmental intervention.[152] Will there be a net benefit to intervening, and how can the costs and benefits be assessed? Part IV looks at examples of input norms that exist without the support of any government adoption. Part V examines norms that pre-date laws but become incorporated into the substantive laws, causing a "hybrid system"[153] of control to govern behavior.

With norms that arise from and are products of governmental intervention, discussed in Part VI, the government has already decided to intervene by passing a statute, or the parties have decided to invoke the law by making a term adjudicable. The intervention of law affects individuals in a variety of ways. These include raising the cost of non-compliance,[154] creating enforcement norms (secondary effects),[155] and perhaps fostering an internalization of the norms.[156] The accommodation that the brain makes and the actions taken in response to the laws and to the possible responses of others who are themselves responding to the law is similar to the tradeoff that the individual makes when responding to others when there is no law to begin with and one is deciding how to behave in an encounter with another. However, there may be differences between norms that originate as inputs and those that are products of laws. Those differences will be considered later.

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150. *See* McAdams, *supra* note 14, at 340 (defining norms as "informal social regularities that individuals feel obligated to follow because of an internalized sense of duty, because of a fear of external non-legal sanctions, or both").

151. *See id.* at 346 ("Law can influence behavior by changing the norms that determine the meaning ascribed to behavior.").

152. *See* Zasu, *supra* note 37, at 382 ("Social connectedness in premodern society is strong, and the expected level of punishment imposed by social norms is high. As a result, undesirable acts are deterred. In this environment, law, which is costly, is not required. There is only a slim possibility that law can improve such a society. In other words, social norms and laws are substitutable, and there is no reason for the existence of costly formal regulations. In contrast, social connectedness in modern society is weak, and the expected level of punishment by social norms is low. In such a society, only social norms monitor undesirable acts. As a result, such acts are insufficiently deterred. In this envirnoment [sic], law is required even if it is costly (the emergence of law).").

153. *See* David Charny, *Illusions of a Spontaneous Order: "Norms" in Contractual Relationships*, 144 U. PA. L. REV. 1841, 1841–42 (1995–1996) ("The Japanese products liability system and the transactional rules of the American grain industry . . . represent two variants of a particular type of nonlegal governance regime—a type in which the parties devise a fairly comprehensive system that includes written rules of conduct, sanctions, and procedures for enforcement. These systems are established in a two-step process: first, norms evolve as a result of transactors' dealings (as in the grain industry) or industry consensus (standard identifying 'design defects'); second, [a] centralized agency selects among, codifies, and enforces these norms.").

154. Scott, *supra* note 1, at 1626.

155. *Id.* at 1603–04.

156. *Id.* at 1604.

C. Examples: Norms That Are Eligible Inputs and Originate in Non-governmental Actions and That Are Self-enforcing Without Legal Intervention

1. Example One: As a Supplement to Incomplete Contracts Where Law Declines to Intervene: Tipping: Self-enforcing Systems and Institutional Mechanisms

In all societies, parties will engage in exchange transactions and contracts (if available) to secure gains from trade. Since the failure to do so would leave gains from trade unrealized, the incentives will be there to develop mechanisms to support exchanges. Parties will cooperate, even in the absence of a government, to obtain the benefits of cooperation.[157] The parties may create or adhere to norms, such as truth-telling, that then constitute a bedrock of virtues that facilitate all exchanges.[158]

Norms may also arise where a government exists but formulates no positive law on a particular matter and the parties, even if they have entered into an adjudicable contract, have not chosen to include any contract term on a particular matter.[159] When parties subsequently face a possible encounter with another, because parties naturally strive to reduce the costs of dealing with others, norms arise to reduce those costs. The calculus then includes the cost of not adhering to a norm or of adhering to a norm, as well as how this decision will impact a party's ability to get the goods or satisfactions that he seeks and at what cost. Parties, of course, may also directly contract with others to satisfy those preferences. However, transaction costs may discourage or raise the cost of contracting and hinder exchange, leaving parties with an incomplete contract.[160] When those costs prevent complete contracting, parties' goals will not be fully realized. Whether parties on their own can devise solutions or whether law should intervene in private contracts depends on a mix of formal and informal arrangements, including norms and contracts.

An example of a private mechanism governing an exchange transaction is the tipping norm prevalent in the restaurant industry. The contractual governing arrangements include: an employment contract between the service provider and employer, and an implied contract between the restaurant and the patron (e.g., "I will pay for food I order.").[161] Failure to pay for the meal is a breach of an implied contract with the restaurant and constitutes a form of theft of services subject to criminal constraints and also a breach of the express contract with the credit card issuer. Tipping norms, perceived by most patrons as obligatory, function to

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157. *See, e.g.*, ELLICKSON, *supra* note 8, at 123 (discussing interdisciplinary research squaring the assumption of individual self-interest with the "reality of ubiquitous cooperation").

158. *See* MCCLOSKEY, *supra* note 70, at 3–4 (2006) (discussing how honest dealings, which may arise as a social norm, are an underlying virtue of successful capitalist systems).

159. *See id.* at 138 (quoting Jennifer Roback Morse) (noting that partnerships, though often evidenced by contractual agreements, seldom attempt to reduce all eventualities to adjudicable contract terms).

160. *See* Eric Maskin & Jean Tirole, *Unforeseen Contingencies and Incomplete Contracts*, 66 REV. ECON. STUD. 83, 84 (1999) (acknowledging that "transaction costs matter in reality"); Gillian K. Hadfield, *Judicial Competence and the Interpretation of Incomplete Contracts*, 23 J. LEGAL STUD. 159, 159 (1994) (recognizing that contracts may be incomplete, in part, due to drafting costs).

161. Another contract exists between the patron who receives the bill and the credit card company that issues the patron a credit card slip agreeing to pay the charges for the meal after the patron has signed. There is no requirement that the patron put a tip on the credit card slip. *See* Levmore, *supra* note 32, at 1990 (describing tipping as "required neither by law nor contract").

supplement incomplete contracts that fail to specify all of a waiter's obligations.[162] Individual patrons decide, given their preferences and beliefs (these might include rewarding those who work hard and securing good service), how to satisfy their preferences and whether to follow the tipping norm in the expected encounter with the waiters and the restaurant management. The patron, who is trying to satisfy his objectives of getting good service and providing appropriate rewards for others, will make internal tradeoffs in which he will consider the guilt that he might suffer if he refrains from tipping, as well as the possible negative ramifications in terms of expected encounters with others, such as future service at the restaurant (if he is a repeat patron), the possible frown or other reaction that the waiter or manager will deliver if not tipped appropriately, and a possible negative account with the manager or waiter if he fails to tip at all. The patron will consider these tradeoffs while trying to minimize the costs of the exchange of purchasing food and services at a restaurant.

When tipping norms operate in conjunction with private contracts, the result is better than if the parties operated solely by private contract.[163] The contract between the waiter and the employer is incomplete since it is hard to observe or measure the waiter's efforts, making it difficult to fix appropriate compensation. The patron, however, can easily observe the waiter's efforts and attach an appropriate amount to account for the quality of service.[164] The norm of tipping between ten to twenty percent of the bill incentivizes the waiter to provide excellent service, which in turn ensures that all parties are better off.[165] The contract at a fixed wage, plus tips (through a norm), constitutes an arrangement preferable to either a pure fixed-wage contract or to a fixed-gratuity contract on all bills, or otherwise built into the price of the menu items. If restaurants imposed a fixed gratuity on all patrons,[166] the restaurant owner would be paying some waiters too much and other waiters too little since the compensation would not distinguish between relative levels of effort.

Another alternative is for restaurant patrons to negotiate a tip each time they purchase a meal *ex ante* by contract. This would require considerable time and effort. Thus, with no norm to set the parameters, the patron would experience uncertainty about the right amount to tip, similar to the kind of uncertainty experienced by foreign travelers who are often unsure of the tipping norms abroad. The norm functions as a cost effective way of navigating in the environment. A further option could be governmental regulation of tipping, where restaurants would be required to pay a pre-set amount to be added to the fixed wage. Given the measurement difficulty, all these alternatives are costly. The arrangement of a tipping norm helps to reduce these transaction costs and the uncertainty associated

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162. *See id.* at 1991 (noting that patrons have more information regarding a waiter's performance than does the waiter's employer; as such, the patron is in a better position to furnish a performance-based reward to the waiter).

163. The notion that contracts may be incomplete in some instances and that norms may help parties reach optimal arrangements or overcome bargaining imperfections mirrors the willingness of law to supply low cost default rules when contracts are incomplete. In each instance, the optimal mix of legal and informal arrangements where "governance is costly, the least cost method will get chosen from among the available institutions, whether it be state law or a private alternative." DIXIT, *supra* note 13, at 4.

164. Levmore, *supra* note 32, at 1991.

165. *See id.* (explaining how tipping results in higher compensation for the waiter and could result in better service for a customer).

166. This is sometimes the norm with large groups. *See id.* at 1994–95 (discussing fixed service charges).

with individually negotiated tips. Depending solely on private contractual arrangements, between the employer and waiter or between the patron and the waiter, to decide the tip amount prior to the rendering of any service would be unlikely to achieve the goal of incentivizing the server and thus, securing the best service for the customer. The private parties could not set an appropriate sum ahead of time for the same reason the government could not do so: transaction costs.[167]

In this context, as in many others, the question is: Given the problem that the norm is solving, would an alternative feasible arrangement[168] be better? Where the tipping norm supplements the contract, the law does not intervene.[169] Deciding whether the non-governmentally originated tipping norm should be legally enforced through a positive law or incorporated into a legally enforceable contract depends on whether the norm is achieving its goals of incentivizing servers, solving the principal-agent problem—not otherwise resolvable by contract—and furnishing the patron the opportunity to evaluate the level of service.

Since the norm has an evaluative element built into it (designed as a standard to be decided by patrons after services are rendered because it cannot be decided ahead of time), which is not observable by lawmakers, the law would have difficulty deciding precisely on a tipping schedule. Given that the government cannot adequately judge the level of service, intervention would not yield net benefits.

Using a comparative analysis of alternatives, with "the least-cost method" likely to prevail,[170] it is understandable why tipping at fast food restaurants is comparatively rare.[171] Norms in these restaurants do not arise because there is no reason to think that the parties cannot achieve an optimal contract. Saul Levmore explains the absence of tipping norms in such contexts as follows: "[T]here is no gain from using the customer (and the social practice) to enhance the employment contract. The employer has standardized the employee's task down to the details of how customers are greeted, and supervisory employees can directly monitor virtually everything that customers observe."[172]

Norms arise as an alternative institutional arrangement only when there are cost advantages to using them as compared to relying on private contractual or governmental substitutes.[173]

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167. The same problem of determining an appropriate wage by contract arises in the principal agent context. It is difficult to fix a sum ex ante for agents' performance ex post given the inability of the principal to observe or monitor the agent's efforts, and performance. Those barriers to contracting help to explain a different kind of institutional solution in the principal-agent context, namely, the law supplied obligation of fiduciary duty. *See* Robert Cooter and Bradley Freeman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. Rev. 1045, 1048–49 (1991) (discussing the fiduciary relationship as a solution to the costs of contracting to solve the principal-agent problem).

168. *See* Oliver E. Williamson, *Public and Private Bureaucracies: A Transaction Cost Economics Perspective*, 15 J. L. ECON. & ORG. 306, 316 (1999) (suggesting "remediableness criterion, with its continuous focus on alternative feasible modes," as the best way to address "real issues").

169. As Levmore points out, tipping is "required neither by law nor contract." Levmore, *supra* note 32, at 1990–91.

170. DIXIT, *supra* note 13, at 4.

171. Levmore, *supra* note 32, at 1993.

172. *Id.*

173. *See id.* at 1990–97 (discussing the norm of tipping, which is widely practiced although not required by law or contract, as a useful supplement to contract).

The ability of a norm to supplement private contractual arrangements and to generate extra effort—and thus, more overall gains—is context dependent. It must be judged by comparative cost as well as by the ability to incentivize effort and maximize overall welfare.[174] In settings where there is no reason to think that the patron is better able to judge the value of the services than the employer (e.g., the fast food industry), no norm for ex-post tipping arises. In other situations, the possibility of competition among potential tippers means that tipping is not an efficient arrangement.[175] For example, if students could offer tips as supplements to teachers, the tipping norm would have perverse effects.[176] The norm would not incentivize the teacher to provide greater effort for all students, but to selectively help the biggest tippers.[177] To discourage such tipping by students, norms exist against these arrangements. Norms in the teaching context, at least in the pre-collegiate setting, involve small or de minimis gifts.[178] Gifts are rare in the collegiate setting.[179]

Thus, in some situations, tipping norms do not arise and are actively discouraged by other rules, laws, and norms. In settings involving the employment of public servants, the tipping norm would not work well to supplement the private contractual arrangements that a public servant, such as a police officer, has with the city; and so, no tipping norm arises. Moreover, there are norms and rules against tipping or rewarding police officers.[180] Society does not want crime victims competing to see who can incentivize the police officer the most. First, the employer can easily judge the efforts of the police officer because of its access to information about arrest results and other data.[181] Second, any possible cost advantages in terms of supplementing an incomplete contract would be more than offset by the cost of rearranging police efforts to benefit the largest tipper and of hindering other goals of law enforcement (such as solving the most heinous crimes).[182]

2. Example Two: Airport Queuing: Providing Flexibility to a Rule in a Private Context: A Self-enforcing Norm with No Law Involved

Sometimes a norm operates in conjunction with a private rule to provide greater flexibility in dealing with exigent contingencies.[183] They operate together to maintain order and achieve greater efficiencies. At airports, for example, in order to maintain order, airline ticket counters have rules governing passenger ticket lines. Yet, there is an exception—a norm that allows someone about to miss a plane to go to the head

174. *Id.*

175. *See id.* at 1994 (noting that, rather than generating greater effort on a service provider's part, tipping may simply incentivize the provider to favor the most generous tippers, and those served "might be better off with a no-tipping norm").

176. *Id.*

177. Levmore, *supra* note 32, at 1994.

178. *See id.* (explaining why "professors do not expect or accept gratuities from their students").

179. *See id.* (noting that professors do not expect gifts from students).

180. *Id.*

181. *Id.*

182. *Id.*

183. Levmore, *supra* note 32, at 1998.

of the line despite the rule.[184] The exception is not explicit since it is not built into the price of the ticket. Airlines intervene on the side of the norm by announcing the exception to the rule: "Will all passengers on the 8:15 to New York come to the head of the line?" The norm and the airline rule operate through private enforcement. The norm acts as an efficient coordination mechanism[185] because it is not in the airline's best interest for the plane to fly half-full. The airline also does not want to permanently alienate late-arriving customers who are not entitled to a fare refund even if they miss their flight. Airlines could not, as easily and at such a low cost, achieve these goals without a private norm. Such a norm incentivizes airlines to create rules in the first place because they can rely on a norm to allow for later flexibility.[186]

In such cases, the norm operates effectively in conjunction with a private rule, softens the effect of the rule, and provides flexibility when needed. The law does not intervene in such cases: "Sometimes, as here, a norm provides relief where a rule imposes undue costs under particular circumstances."[187] As a result, parties subscribe to a norm partly because it is in their own self-interest since they may need flexibility and relief from the rule in the future. The individual in line who is deciding whether to let someone cut in line weighs his own preferences for getting to the head of the line as quickly as possible against the possible negative encounters with the late-arriving passenger and with other passengers who are willing to be flexible. The resulting norm is the product of an exchange. The exchange results when the passenger already in the line weighs the possible opprobrium that he would suffer if he refused to allow someone to cut in line against his own goal of advancing to the head of the line as quickly as possible while minimizing the transaction costs of navigating airport lines and weighing the possible need for a reciprocal benefit[188] in the future. The law refrains in part because the parties' norm (a type of exchange) solves the cooperation problem; in addition, there are no externalities as all the effects are concentrated on passengers and the airline.

Norms may also act to soften a judicially adjudicable law. An example is the norm that exempts from the speed limit laws someone who is speeding while driving a heart attack victim to the hospital. The concept of negligence incorporates norms

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184. *If You Are Late for Your Flight*, ABC ARTICLE DIRECTORY, http://www.abcarticledirectory.com/Article/If-You-Are-Late-For-Your-Flight/345776#.ULQIQoagGSo.

185. *See* Cora B. Excelente-Toledo & Nicholas R. Jennings, *Learning to Select a Coordination Mechanism*, Autonomous Agents & Multiagent Sys. 1 (2002), *available at* http://eprints.soton.ac.uk/256870/1/cora-aamas-02.pdf ("Effective coordination is essential if autonomous agents are to achieve their goals in a multiagent system. Such coordination is required to manage the various forms of dependency that naturally occur when the agents have inter-linked objectives, when they share a common environment, or when there are shared resources. To this end, a variety of [coordination] mechanisms have been developed to address the coordination problem at different levels of abstraction.").

186. Of course, if an airline thought that a particular party was a serial violator, it might decline to give him the flexibility to violate the rule.

187. Conversation with Peter M. Gerhart, Professor of Law, Case Western Reserve University School of Law (June 18, 2012).

188. The belief that one will interact with others in the future serves to promote cooperation since one fears that a failure to cooperate will generate an equally unhelpful response by one's counterparty in a future interaction. Binmore discusses "[t]he idea that reciprocity is the mainspring of human sociality [that] goes back nearly as far as there are written records." BINMORE, *supra* note 72, at 77; *see also* Robert E. Scott, *A Theory of Self-enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1642 n.4 (2003) (arguing that parties leave contracts incomplete with "an intent to use self-enforcing mechanisms such as reciprocity").

that allow us to speed if an emergency exists.[189] The norm allows for particularized justice and supplements the law rather than the other way around.

In the two hypotheticals involving exceptions, the question arises of whether law could improve outcomes by enforcing a norm of flexibility. On one level, since the norm seems to be functioning well currently without legal sanctioning, law would be superfluous. Reciprocity may play a role in the effectiveness of the informal norm since airline passengers are sufficiently likely to face the prospect of encountering unexpected difficulties after arriving at the airport. When such conditions exist, the affected passengers may make accommodations in order to increase the odds that similar accommodations will be made for them in future transactions.[190] Second, the norm is based on an exception to the rule and requires highly contextualized knowledge about the party seeking an exception. The greater distance from the underlying encounter might make a legal institution less able to judge the propriety of an exception.

Third, the nature of a flexible norm is such that it lacks some of the characteristics of a rule of law.[191] Its vagueness may prevent the norm, if incorporated into law, from publicly delineating the actual parameters of the exception. It will remain ambiguous and unhelpful to people trying to plan their behavior. Fourth, there is no problem of externalities since most of the ill effects of a late arriving passenger are focused on the offending party.

3. Example Three: The Maghribi Traders: Norms, Coalitions, and Networks as Private Enforcement Mechanisms for Contracts: Norms That Are Largely Self-enforcing but Have Some Limits on Self-governance

Norms functioned to supplement incomplete contracts with the eleventh-century Maghribi traders. The encounter between delegators (i.e., principals) and delegates (i.e., agents) involved interactions that called for resolution. The resulting exchange took the form of certain norms. In these settings, potential performance by the agent for pay opened up the possibility of divergence and shirking or theft by the agent, matters about which principals were acutely concerned. The principal had to make an internal tradeoff between his objectives, preferences, and beliefs. His preferences would have included engaging in a profitable venture at the least cost. He would have weighed the possible divergence by an agent as a cost; if his prospective agent were a friend, he would have weighed the possible loss of friendship as a cost he would have incurred if he had not hired the friend as an agent. The principal's decision would have depended on whether the loss of the revenue stream from shirking or divergence would have been greater or less than the loss of the value of the friendship. The principal would also have considered, once the norm had been established, whether to have adhered to the Maghribi norm of hiring only members who had not cheated[192] and the possible negative effects on business of not

189. *See, e.g.*, JAMES M. ROSE, N.Y. VEHICLE & TRAFFIC LAW § 34:19 (2d ed. 2012) ("The courts have held that, in a true emergency, speed limits may be exceeded . . . .").

190. GREIF, *supra* note 24, at 144; ELLICKSON, *supra* note 8, at 154–55.

191. *See* H.L.A. HART, THE CONCEPT OF LAW 89–96 (1961) (describing both the deficiencies of norms as compared to formal laws, and the evolution from norms to enforceable rules of law).

192. GREIF, *supra* note 24, at 59.

having adhered to the norm. The principal would also have weighed the benefits of having adhered to the norm in terms of minimizing the costs of divergence.

The comparative cost analysis differs from that of the tipping example because in the eleventh century the state was weak; therefore, the main institutional alternatives available to the principal were contracts and norms.[193] The success of the informal Maghribi institutions, including norms, that arose to govern these principal-agent relationships depended on a variety of specific factors including the following: (1) information-sharing mechanisms;[194] (2) links between a single present transaction and future transactions;[195] (3) cultural norms of adhering to certain hiring practices and norms of collective punishment;[196] and (4) beliefs about others sharing information and adhering to hiring and punishments norms.[197] The reasons why a collective enforcement coalition prevailed and was successful over other alternatives, such as contracts, legal enforcement, or bilateral trading, are examined below. The discussion highlights how a variety of institutional elements combined to allow parties to solve the critical economic problem of agent opportunism. The norms produced value by minimizing transaction costs, specifically agency costs.[198] The limits of the Maghribi self-governance mechanism will also be addressed.[199]

The Maghribi traders employed agents over long distances, which presented an opportunism problem as a result of the impersonal trading context.[200] Trading was "characterized by asymmetric information, slow communication technology, inability to specify comprehensive contracts and limited legal contract enforceability."[201] Solving this principal-agent problem by contract[202] was therefore difficult; yet resolving it was crucial to enabling trade to thrive over long distances.[203]

The Maghribi were an ethnic and religious community with a trading club whose practice was "to hire only member agents" and "never to hire an agent who had cheated another member."[204] The Maghribi merchants responded by applying a norm of multilateral sanctions against agents who defected by cheating.[205]

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193. *See id.* at 58 ("Despite their efficiency, however, agency relations are not likely to be established unless supporting institutions are in place, because agents can act opportunistically and embezzle the merchants' goods.").

194. *Id.* at 59.

195. *Id.*

196. *Id.*

197. *Id.* at 82 (listing the factors that "make collective punishment effective" and encourage coalition members to commit to specified hiring practices).

198. GREIF, *supra* note 24, at 87.

199. *See id.* at 87–88 (discussing the deficiencies of Maghribi self-governance).

200. Unless they were to accompany the goods, however, the principal traders needed to employ agents over long distances and to turn over goods and capital to the agents. This presented shirking problems and opportunities for agents to embezzle from the merchants. *Id.* at 58.

201. *Id.* at 85–86.

202. The Maghribi did enter into contracts with agents; however, these were not legally enforceable. *See id.* at 64 (discussing obstacles to enforcing contracts).

203. *See id.* at 88 ("The same factors that ensured . . . self-enforceability prevented . . . expanding in response to welfare-enhancing opportunities.").

204. GREIF, *supra* note 24, at 58–59.

205. *See id.* at 66–67 (detailing the collective punishment of an agent accused of dishonesty in Jerusalem; his contracts were cancelled by merchants "as far away as Sicily" once the allegations of dishonest conduct reached them).

Additionally, the Maghribi adopted "rules of conduct"[206] that allowed a merchant to determine if an agent had cheated him.

The system worked well in the policing and monitoring of agents and provided value to both principal and agent members. Agents benefited because the members paid a wage premium[207] that was made possible in part by the decreased likelihood of cheating. Merchant principals could rely on the threat of multilateral sanctions effectively deterring agents from cheating,[208] which allowed them to pay a lower wage premium than if the merchant depended on bilateral sanctions, making the agency relationship efficient.[209] Outside the coalition, the "wage required to keep an agent honest . . . is higher."[210] Thus, merchants inside the coalition paid outside merchants a lower wage since there were other institutional mechanisms to keep the agent honest. The relative success of the alternative informal institutions depended on the relative ability of the punishment mechanism (e.g., bilateral versus multilateral) to sanction cheaters, detect deviant behavior, transmit information, and achieve efficiency and profitability.

The ease of transmitting information within the network promoted the detection and reporting of cheating to other members.[211] Information linked an individual transaction and "information-sharing transactions among the merchants[,]"[212] which helped foster a belief that "opportunistic behavior is likely to be detected."[213]

The Maghribi system of multilateral punishment depended on the parties knowing that sanctions would be effectively imposed against agents who defected, and the ability to punish depended on accurate transmission of information about an agent's cheating.[214] This may explain why the Maghribi did not trade with some non-members, such as the Italian Jews.[215] Uncertainty about the truth of the outsiders' accusations would impair the functioning of the multilateral system of sanctions in such contexts.

The multilateral system for sanctioning opportunism arose in the context of ineffective national states and state courts with relatively limited and local jurisdiction.[216] In this atmosphere, a need developed for an alternative system to constrain such behavior. Adherence to the system itself operated as a norm that influenced behavior through the prospect of economic punishment rather than any

206. *Id.* at 59. Greif characterizes the merchant rules as "social norms" since they were "rule[s] that [were] neither promulgated by an official source, such as a court or legislator, nor enforced by the threat of legal sanctions but [were] nevertheless regularly complied with." *Id.*

207. *Id.* at 68.

208. *See id.* at 80 ("[A] multilateral punishment strategy supports cooperation . . . by . . . decreas[ing] the probability that a cheater will be rehired.").

209. GREIF, *supra* note 24, at 79–80.

210. *Id.* at 82.

211. *See id.* at 81–82 ("The fact that within a coalition each trader is known to the others enables informal information flows . . . to facilitate monitoring and to inform traders about cheating.").

212. *Id.* at 59.

213. *Id.*

214. *Id.* at 59, 81–82.

215. GREIF, *supra* note 24, at 78.

216. *Id.* at 64, 314.

internalized guilt or shame.[217] The effort to devise mechanisms to solve the shirking problem demonstrates how people behave in the absence of legal institutions to achieve their goals and to prosper. Non-governmental mechanisms will arise to reduce the drag on gains from trade that would otherwise have diminished the surplus available to the parties and rendered agency relations costly or nonexistent.

The lesson of the Maghribi traders is that parties will devise mechanisms to achieve the function of deterring cheating as a means of reducing the costs of exchange. Parties deciding on the terms of trade, including how to structure trade, will consider the possible costs of unconstrained opportunistic behavior and consider whether to devise or adhere to norms to lower the costs of trade. The norm of adherence to the merchant system governed the actions of the merchant community and effectively policed opportunism. Communities that lacked private mechanisms for punishment for deviant behavior did not flourish to an efficient level until those mechanisms were in place.[218] The success of the coalition demonstrates "the importance of contract enforcement institutions in the operation of markets."[219]

Although the government did not play a role in imposing sanctions against defecting agents, studying the Maghribi reveals that their private enforcement mechanisms intended to deal with agency costs as well as the institutional elements that made it possible to police, monitor, and punish deviants; studying the limits of such a system can help identify (1) the criteria for successful self-enforcement;[220] (2) the "limits of self-governance;"[221] and (3) identify cases where other institutional mechanisms might be useful. An unanswered question could arise: Should a government incorporate similar merchant norms into a statute, common law rule, or the parties' contract or punish defecting merchants with legal penalties if they fail to adhere to the norms? The answer depends on whether the non-governmental means under the particular conditions are effective and self-enforcing. If so, there would be no reason to intervene. If the multilateral mechanism or other norms deteriorate or the nature of the market differs from the Maghribi's by not offering the opportunity for so many informational flows among a close knit group, then a strong government would have to decide whether it should legally sanction breaches of merchant law to deter opportunism and whether there would be any negative effects from such intervention. The government should use an analysis based on which law or which combination of laws and informal arrangements would be most effective in cost-minimization and achievement of the parties' goals.

4. Example Four: A Complete Private Ordering System That Shuns Outside Legal Enforcement: The Diamond Industry

The diamond industry furnishes a modern equivalent to the Maghribi. In this industry, trading norms also develop in the context of a social and ethnically tight knit community. The industry successfully relies on a combination of norms, trade

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217. *Id.* at 67.

218. *See id.* at 105–08 (discussing the importance of the Hanseatic league in contributing to prosperity by curbing the abuses merchants suffered).

219. *Id.* at 88.

220. *See id.* at 58 (examining the necessary framework of trust, familiarity, and mutual punishment among the Maghribi required for the success of a reputation-based economy).

221. DIXIT, *supra* note 13, at 13; *see also* GRIEF, *supra* note 24, at 62–63 (exploring the "commitment problem" and the ease with which an agent could embezzle goods without a formal legal system).

rules, and extra-legal enforcement to solve problems in the trade. The success and persistence of these norms indicate that they are superior to legal enforcement.[222]

Enforcement depends on parties voluntarily belonging to diamond clubs that adopt trade rules to govern diamond sales.[223] Although parties can purchase diamonds on the market, most purchases take place through a club with its own norms and rules.[224] Several norms prevail. First, secrecy norms discourage litigation.[225] Second, norms favoring extra-legal "voluntary resolution of disputes"[226] are embodied by mandatory pre-arbitration proceedings.[227]

The successful policing of diamond clubs' members depends on a combination of traditional social bonds and the posting of a reputation bond that will be forfeited if an adverse judgment is rendered in an arbitration proceeding.[228] Upon judgment, the member faces the possible loss of future information about other members, an adverse effect on his reputation, and the social consequences of guilt and shame.[229]

The diamond industry and other homogenous groups are likely to encourage "extralegal contractual regimes . . . when preexisting or gradually evolving social relationships provide a basis for nonlegal [extralegal] commitment[s] without large additional investments in developing a bond . . . [since they are] incrementally less costly . . . when they are parasitic on background habits or understandings built into the culture in which these bonds are formed."[230] A foundation of embedded norms and customs is imported into the diamond industry rules and helps make such practices successful and profitable.[231] These norms have survived and thrived despite a decline in the force of Jewish law and changing conditions, including a less homogeneous group with fewer social connections.[232] Should certain members of the diamond trading community in the future refuse to adhere to the norms of secrecy and arbitration, then those who want the norm to be followed in an exchange may decide to make the norm a term of an adjudicable contract.

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222. Bernstein, *supra* note 148, at 157.

223. *See id.* at 119–21 (discussing the prevalence of bourses and their use of internally developed trade rules).

224. *Id.* at 119–20.

225. *Id.* at 134–35.

226. *Id.* at 124.

227. *Id.* Members of the group are discouraged from seeking legal redress much as the Shasta County residents studied by Ellickson were. ELLICKSON, *supra* note 8, at 135. Other norms include using a broker to mediate sales between buyers and sellers by sealed offer, the use of which discourages brokers from falsely representing the terms of the offer and opportunistically pocketing a part of the sale price. Bernstein, *supra* note 148, at 122–23.

228. Bernstein, *supra* note 148, at 138.

229. *Id.* at 139.

230. *Id.* at 140 (quoting David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 393, 423–24 (1990)) (footnote omitted).

231. *See* Bernstein, *supra* note 148, at 141 (discussing how the diamond industry trade rules grew out of traditional Jewish law); *see id.* at 157 (noting that the diamond industry's trade rules have promoted low cost and fast dissemination of information).

232. *Id.* at 141–42.

5. Example Five: Signaling Communicative Norms with Private Promulgation and No Legal Implementation: Dressing for Success

In certain contexts, the precise role that law can play, given the existence of social norms, depends principally on the purpose of the norm (such as solving the principal-agent problem) and the effectiveness of various institutions in achieving this purpose. In other environments, the nature of the norm itself suggests that the role of law should be limited even apart from whether there are institutional networks to enforce the norm or not. Norms of social etiquette originally involve norms not likely to cause an externality.[233] In such cases, "rules are more likely to be propagated privately, based on the incentives of individuals to study or transmit them,"[234] and they are thus likely to be self-enforcing.

Parties sometimes communicate through norms that have signaling or expressive value.[235] A potential employee can choose to follow the norms of dress and timely arrival for an interview or choose to rebel by not following the norms. Respecting the norm creates private benefits for the adherent[236] since it may signal to the employer that the applicant for the job will conform to the culture of the organization and be sensitive to the feelings of others. This impression increases the adherent's chances of being hired. These types of norms serve to build trust and lower transaction costs because conformity to the norms provides an applicant screening mechanism for potential employers and others.

In terms of the earlier framework of norms as a form of exchange, one can think of the dress norm as a non-adjudicable institution that is the outcome of an exchange between the applicant and the firm. The applicant has preferences about whether to dress up but will decide how to behave and reach a resolution in light of an expected encounter with others, particularly the employer.

Norms that act as signals would lose their value if the state were to mandate that job applicants comply with norms of dress or timeliness since the adherent might be conforming because of the fear of punishment rather than obeying, voluntarily, as a means to signal to an employer that they are valuable team players who will conform in ways that will benefit the employer. Mandating the norm would muddy the signal that the employer wishes to receive. State intervention would interfere with the exchange being made by the job applicant. The applicant considers how much he wants to pursue a personal preference to dress down (forfeiting the preference is a cost) and resolves that preference in light of the expected reactions of others. How that applicant makes the tradeoff is useful information that would be lost with coercive punishment. In other instances, to be examined later, the state can intervene to enforce the norm without obliterating the signal that is the purpose of adhering to the norm. In this case, a comparative cost analysis seems the best way to decide if legal intervention is justified.

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233. *See* GREIF, *supra* note 24, at 136 (noting that where an actor learning the rule imposes an externality on others, a "dedicated public organization" would be better suited to propagating the rule).

234. *Id.* at 136–37.

235. This is an example of a norm that works best through "private propagation" without legal intervention. *Id.* at 136.

236. Scott, *supra* note 1, at 1624.

V. NORMS AS INPUTS THAT EVOLVE FROM SELF-ENFORCING TO INCORPORATED-INTO-LAW OR THAT FUNCTION AS A COMPLEMENT TO LAW IN EXCHANGE AND NON-EXCHANGE TRANSACTIONS

A. Inputs (i.e., Norms) That Are Incorporated: The Migration to Law

1. Example One: Function: Minimizing the Costs of Transacting with Others: Reducing Measurement Costs: Norms That Are Initially Self-enforcing and Then Incorporated into Law: Formal Weights and Measures

When parties develop norms on their own to reduce uncertainty and maximize gains by minimizing the costs of exchange, questions arise as to why and when the law might choose to intervene to displace private norms (while using the same content of the existing norms) or, in other instances, to supplement the existing norms by making the breach of them legally sanctionable. The reasons for the legal intervention, whether in the form of displacement or supplementation as part of a "*hybrid system*," will be examined with each example below.

One instance when law has displaced informal norms involves the introduction of standardized weights and measures. The standardization of weights and measures emerged initially as norms that minimized measurement costs in markets.[237] These devices relieved parties from devoting resources to measurement, and thus increased the gains from trade and encouraged trading.[238] Later formalization by the state makes sense. Informal norms became less efficient in totally impersonal exchange and were subsequently incorporated into law.[239] State enforcement, via random government checking, provides a low-cost way of punishing cheating.[240] The law can at low cost provide a coordination point.[241] Intervention would not destroy the function of the norm as it would with signaling norms. There would seem to be benefits from public pronouncements as they would provide a cognitive foundation for parties buying scales and weights. Government enforcement must be cheaper than private enforcement in order for it to be adopted.[242]

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237. NORTH, *supra* note 5, at 41.

238. Professor North notes that these devices had features "that make the exchange viable by reducing measurement and enforcement cost." *Id.* at 41.

239. *Id.* at 46–47.

240. *See* RONALD EDWARD ZUPKO, REVOLUTION IN MEASUREMENT: WESTERN EUROPEAN WEIGHTS AND MEASURES SINCE THE AGE OF SCIENCE 183–84 (1990) ("Parliament in 1858 mandated that inspectors examine the weights and measures of anyone selling goods in streets and public places.").

241. *See id.* at 183 (noting that the ability of the law in 1824 to successfully overcome local customary measurement norms was complicated by the entrenchment of the local variations and some resistance).

242. The displacement of the business norms of measurement with a legal rule that mimics the norms makes sense because "technological change tended to lower measurement costs and encourage precise, standardized weights and measures." NORTH, *supra* note 5, at 46. Zupko highlights the large variations in measurement and "metrological proliferation" due to local customs as well as a lack of consistency caused by the government itself adopting inconsistent standards. ZUPKO, *supra* note 240, at 14. When technological breakthroughs occurred, the law followed in 1824 by streamlining and unifying the standards and legislating out of existence prior inconsistent standards. *Id.* at 177–78. The adoption of the metric system by the government followed in 1965. *Id.* at 177, 270.

In other instances of exchange, measurements may be standardized through organizations such as better business bureaus or credit rating agencies, both of which can reduce the measurement costs of parties trying to determine the value of certain products or companies.[243] The development of mechanisms for auditing and accounting also lowers measurement costs for parties in exchange transactions and promote the exchange of information.[244] Standardization makes enforcement easier and cheaper. Moreover, the "increasing complexities of societies" make it more beneficial to have more formal constraints in place as it "raise[s] the rate of return."[245] Of course, once the norm is incorporated into a law, norms of adhering to legal rules reinforce adherence to the law.

2. Example Two: Solving Problems, such as the Principal-Agent Problem and Other Forms of Opportunism, with Norms That Are Incorporated by Law into Contracts: The Plastics Industry

In the form of usages of trade, norms also play an important role in dealing with the recurrent problem of opportunistic behavior arising in the modern commercial context. They can be seen as private efforts to maximize the value of returns to each side and minimize the costs of exchange that diminish the gains from trade in situations where the opportunism may be difficult to control by comprehensive contracting. Norms are eligible inputs for the content of law.[246]

A norm of conduct may arise to deal with certain recurring issues faced by the parties. The main contractual communication may not contain the norm, but it will arise instead as a pattern that exhibits the following express content: If a given contingency occurs, parties will respond in a given manner.

The parties may omit the norm from their express contract thinking that—since they have dealt with the problem in the past and therefore know what will happen as a result of prior express, though informal, communication—there is no need to include it.[247] This is a cost saving argument that might cut in favor of judicial enforceability of a custom. Parties may not even realize, for example, that they need to expressly incorporate trade terms into a contract.

One example of trade usage involves the plastics industry.[248] In these cases, a mold manufacturer may produce a plastic mold for a buyer at great expense due to

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243. *See* NORTH, *supra* note 5, at 41 ("Informal constraints can take the form of agreed upon lower cost forms of measurement . . . and make second- and third-party enforcement effective by specific sanctioning devices or information networks that acquaint third parties with exchange performance (credit ratings, better business beaureaus, etc.)."); *see also id.* at 46 (noting that standardization of measures tends to "lower measurement costs").

244. *See id.* at 41 (noting that the "development of auditing and accounting techniques lowered critical . . . information and enforcement costs").

245. *Id.* at 46.

246. *See* Juliet P. Kostritsky, *Judicial Incorporation of Trade Usages: A Functional Solution to the Opportunism Problem*, 39 U. CONN. L. REV. 451, 465 (2006) ("Whether the law should incorporate a business norm into a contract should depend on whether legal incorporation of that norm can be justified in efficiency terms.") (footnotes omitted).

247. *See* Gord Indus. Plastics, Inc. v. Aubrey Mfg., Inc., 469 N.E.2d 389, 391 (Ill. App. Ct.) (1984) (indicating that if the "mold removal fee is customary in trade" then "such a term [becomes] incorporated into the parties' contract").

248. *See id.* at 392 (discussing whether mold removal fees are customary in the plastics industry). *See generally* Kostritsky, *supra* note 246 (discussing other examples).

the large engineering and other sunk costs. A buyer may agree to pay for the manufacture of the mold and agree to buy items manufactured from the mold. This buyback arrangement allows the manufacturer to recover the sunk costs of engineering. If a buyer demands the mold while canceling its buyback arrangement, the trade usage norm requires the buyer to pay a "mold removal fee."[249]

The norm curbs opportunistic behavior by buyers. Without the norm, buyers could deprive the seller of the ability to recoup its investment in a way that would potentially be costly to solve by contract.[250] The norm is an exchange that results from the encounter of the manufacturer and buyer and thus reduces transaction costs. At the same time, the norm discounts the cost to the buyer because without an expectation of adherence to it, the seller would charge a higher price to the buyer based on a markup for the possibility of opportunistic removal of the mold.[251]

Whether the norm should be enforceable by the judiciary or by reputational sanctions alone depends on the cost and benefits of judicial recognition. Under the Uniform Commercial Code, trade usages are part of the bargain unless the parties negate them.[252] The primary justification for the legal default rule incorporating trade usages into parties' contracts is that it enhances value for both parties by saving them the transaction costs of express incorporation.[253] A party may still face the prospect that its counterparty will act opportunistically over the course of the contract since the mold manufacturer does not know a buyer's proclivities for opportunism in advance. Legal incorporation curbs the potential for such opportunism and increases gains from trade.

3. Example Three: Coordination Norms That Are Seemingly Self-enforcing but Co-exist with Organizations and Law: Driving on the Right

With certain types of regularities of behavior, self-interest makes the norm mostly self-enforcing. This raises the question of why law would intervene. The norm of driving on the right side of the road is an example of a self-enforcing norm. It is largely self-enforcing because the failure to follow it will result in harm or even death to the deviant, so ordinarily there will be no need for the law. A preference for one side or the other may or may not exist to begin with. If no preference exists, the party's choice is determined mainly by what one decision maker thinks that the other will do. As Greif explains, "[t]he belief that everyone else will drive on the right motivates an individual to do likewise."[254] However, the law may become involved even when a coordination norm governs behavior.[255]

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249. *Gord*, 469 N.E.2d at 392.

250. *See* Kostritsky, *supra* note 246, at 491–92 ("[I]f one party seeks the court's help, it may indicate that the informal mechanisms are not working or are not likely to work, since otherwise the party bringing the lawsuit would not undertake the additional costs of legal enforcement.").

251. *See id.* at 505 ("[T[rade usage itself constitutes one means of controlling opportunistic behavior and maximizing the benefits of the exchange.").

252. U.C.C. § 1-303, cmt. 3 (2012).

253. *See* Kostritsky, *supra* note 246, at 514 ("[A] prime advantage of the incorporation strategy is that it saves parties transaction costs.").

254. GREIF, *supra* note 24, at 36.

255. *Id.* at 37.

Nonetheless, even if parties develop a norm of driving on the right, there would be advantages in adopting or formalizing the rule. Doing so would "provide a shared cognitive system, coordination, and information . . . ."[256] Rule adoption could educate newcomers on the norm. The involvement of organizations to implement the rules would "facilitate the creation of the corresponding beliefs,"[257] including the belief that "others will follow [the] rules."[258]

4. Example Four: Neighborhood Norms Plus Law to Solve the Problem of Externalities: Lawn Care

Where certain behaviors may have positive or negative effects, a consensus will develop around behaviors that generate positive and avoid negative effects. Cutting one's lawn and keeping one's house in good repair are prime examples of such behaviors. In the majority of neighborhoods, a consensus builds in favor of behaviors that have positive effects.

In these situations, one neighbor is incentivized to keep his lawn cut and his own house in good repair in order to maintain the value of both the house and the neighborhood.[259] However, if his neighbors fail to maintain their properties, the value of his home could deteriorate. The other neighbors then become enforcers of the social norm or consensus in favor of keeping one's house and lawn in good condition.[260] However, if a homeowner is not motivated to comply by the opportunity to gain the esteem of others, the law often intervenes to deal with a deteriorating home if it has become an eyesore in the neighborhood.[261] In such a situation, the homeowner would be placing an externality on others and the law would notify or penalize the homeowner in accordance with home-condition statutes.[262]

VI. NORMS THAT ARE THE PRODUCT OF A STATUTE OR A RULE AND MAKE ENFORCEMENT OF LAWS OR RULES POSSIBLE EVEN WITH NO OR MINIMAL SANCTIONS BY LAW: SOCIAL ENFORCEMENT NORMS

Two other distinct types of norms exist. The first type does not arise spontaneously or by evolution to solve problems of cooperation in a cost-minimizing way. This norm does not predate the law and is instead empowered to exist by the passage of the law. The second norm is created through a law for the purpose of changing an existing dysfunctional norm. In both of these cases, the law plays a different role than it does where it decides to incorporate pre-existing norms. Rather than allowing the parties to solve their problems on their own or to supplement such pre-existing norms, the law plays a more active role in creating new norms or demolishing existing norms.

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256. *Id.*

257. *Id.*

258. *Id.*

259. McAdams, *supra* note 14, at 359.

260. The desire for esteem may motivate neighbors to comply. *Id.* at 355, 359.

261. *See id.* at 397 ("[T]he law can strengthen a norm by imposing sanctions on those who violate it.").

262. *See id.* at 391 ("[A]n important function of law is to shape or regulate norms.").

When there is no pre-existing norm, norms are not embedded in a way that currently affects parties' choices or will affect the decision of whether a law is needed, as happens when existing norms already operate. A law may be passed to publicize the state's view of what the norm should be and to stimulate secondary enforcement mechanisms.[263]

The justification for the law acting to stimulate or overturn norms should be that the law needs to intervene because the parties cannot reach efficient or fair results on their own. The content of the law cannot be based on an underlying norm if one does not exist.

A. Function One: Empowering Enforcement Norms with the Passage of a Law to Stimulate Secondary Enforcement Mechanisms

Understanding how law affects behavior and predicting those effects allows us to determine how "an alternative complex regime of social control . . . interacts with law in many different ways."[264] Studying the interactions between law and norms is important because the success of the law may depend on its ability to generate norms of social enforcement beyond legal sanctions.

These types of social norms generated by the passage of a law are distinct from the norms that arise, perhaps spontaneously, to promote cooperation and coordinate behavior. A norm that arises after the passage of a law follows a different path from the norm that naturally becomes embedded in the culture as part of evolutionary trends toward efficient and stable norms.[265] In the case of embedded social norms that arise before laws are passed, the state may have a difficult time crafting laws that directly reject them.[266] In fact, the ability of the norm to change and shape preferences (as with no-smoking norms, where there was a lack of a shared consensus) seems greater than if the norm predated the law. The ability of the law to overturn embedded norms, which may well have evolved naturally toward stability, efficiency, and fairness, would usually be limited and counterproductive.[267]

One example of a preference that might be enacted into law, which is discussed in the literature, is a tree preference.[268] The passage of an ordinance banning dogs from parks gives effect to this preference by permitting those who prefer trees to sanction violators who choose to bring dogs to parks.[269] Similarly, a law may be passed requiring dog owners to pick up their dog's litter.

In these cases, one could argue that where the nature enthusiast and the dog owner each have different preferences, no norm would arise through repeated interactions between them, which would reveal a strong consensus on which

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263. *Id.*

264. Scott, *supra* note 1, at 1606.

265. *See id.* at 1615 (illustrating how the passage of a law changes a norm).

266. *See id.* at 1612 (explaining that normative constraints by the state are sometimes in tension with norms, and that this conflict is resolved through an individual's "hierarchy of values").

267. There are instances, however, where the law can overturn embedded norms such as dueling norms through legislation. *Id.* at 1623–24. The most effective type of statutes for overturning such a dysfunctional norm will be examined in the next section.

268. *Id.* at 1608–12.

269. *Id.*

preference should prevail. Similarly, although there might be distaste for dog littering, it may not rise to the level of a self-sustaining norm that is enforced through repeated sanctioning of violators. An individual may have an inner conflict between norms; for example, the dog lover may want to be virtuous about picking up dog litter but also may want to avoid appearing silly by doing so. Thus, no social norm may exist before the law is implemented. Certainly, some people prefer dogs to trees and others prefer trees to dogs; but until the law is enacted in favor of trees over dogs in public parks, presumably those who prefer trees will not feel empowered to sanction the dog lovers. Similarly, some parties may share distaste for dog litter, but there may not be enough of a consensus on violations and proper punishment to empower norm enforcers, or else no consensus may have emerged (as in the case of public smoking). Those with disparate preferences will not feel a sense of duty to obey one preference over the other or to sanction violators.

Normally, law would not care about preferences and would remain neutral, requiring dog lovers and tree lovers to work out conflicts they might have about park use through agreement and contract. The dog litter problem, however, may be an externality that is difficult to solve by cooperation due to the collective action problem. The resident of a community often does not know which dog owner is responsible for the dog litter and will have a hard time sanctioning the perpetrator since he will be peripatetic, and once the dastardly deed is done it is difficult to know who is responsible.

Since there is a problem that the law would like to control, the law will intervene. It favors one preference here (i.e., the preference for trees over dogs or for no dog littering over allowed dog littering) and then relies in part on informal sanctions to help achieve that goal.

Passage of a law preferring tree lovers or outlawing dog litter can then unleash a variety of activities and an increased willingness to informally sanction violators, a process less costly than contracting.[270]

Once a law is passed, it empowers people to object. Some people with dogs have conflicting preferences about dog litter.[271] On the one hand, the dog owner may feel embarrassed about carrying around a plastic bag. On the other hand, the owner may also feel virtuous about picking up after the dog. The law legitimizes this feeling of virtue. Dog owners now feel motivated, given permission to feel virtuous rather than silly. Moreover, they gain a sense of esteem from adhering to the law. Others can withhold esteem easily and at a low cost and start punishing violators.[272] Publicity and high detection probabilities can lead to the formation of a norm.[273] A social norm may have a different origin, however, arising in aid to an intervention that was originally prompted by the difficulties of contracting. It may be that these patterns of conduct become internalized for some people who see that by obeying the law, they gain esteem from others.[274] On the other hand, "[o]thers will obey the norm

270. This is an example of an attempt "to explain the mechanisms by which legal expression can affect social norms." Scott, *supra* note 1, at 1624.

271. *See id.* at 1608–09 (setting up an example of laws influencing norms in the context of dog-littering laws).

272. *Id.* at 1618, 1624.

273. *Id.* at 1615 (describing Bayesian analysis of dog owners' sensitivity to increased probabilities of enforcement).

274. There remains the problem of empirically verifying whether the law has actually prompted an internalization or a change in preferences. *Id.* at 1635.

automatically because their respect for law causes them to obey the laws as an intrinsic value. Together these two effects can . . . shift behavior to a new equilibrium."[275]

B. Function Two: Passage of a Law to Contribute to the Refining of the Content of a Norm

Laws may also influence behavior by shaping a norm.[276] For example, there may be a norm of good parenting. As long as no law has been passed mandating that parents put children in car seats, a parent can rationalize his failure to put the child into a car seat as behavior that still comports with good parenting.[277] The parent has his own preferences (for example, to not put the child in a car seat) but once the child seat law is passed, it "expresses a consensus and creates an esteem-based norm defining good parental behavior."[278] The parent now takes his preferences (say, for personal freedom) and arrives at a resolution by taking account of the expected reactions of others and of the price that he will pay if he violates the law.

C. Function Three: Changing Norms: Dueling Norms, No Smoking Norms, and Racial Discrimination Norms

Sometimes inefficient or non-utilitarian norms develop or persist. One example of a persistent inefficient norm is the practice of dueling to protect one's honor.[279] Theory suggests that the practice of dueling arose to promote a culture of "self-help violence to remedy an insult."[280] It developed amongst white Southerners who needed to "maintain their solidarity"[281] to discourage revolts by black slaves.[282] Once slavery was abolished, the dueling norm lived on because it had become internalized and was thus difficult to dislodge. In that instance, two types of laws were passed: (1) those prohibiting dueling and (2) those prohibiting duelers from holding public office.[283] The latter proved more effective in changing the norm.[284]

Other changes to norms occur due to the stimulus of changed economic circumstances that alter "the cost-benefit conditions" for existing norms.[285] Demsetz traces a change in norms regarding hunting among Labradorian Indians.[286] A rise in the monetary opportunities for fur trading prompted the tribe to adopt a system of exclusive hunting rights to give appropriate incentives for hunting sustainably and

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275. *Id.* at 1633.
276. McAdams, *supra* note 14, at 407–08.
277. *Id.* at 408.
278. *Id.*
279. *Inefficient Norms*, *supra* note 35, at 1736; Warren F. Schwartz, Keith Baxter & David Ryan, *The Duel: Can These Gentlemen Be Acting Efficiently?*, 13 J. LEGAL STUD. 321, 335 (1984).
280. Ellickson, *supra* note 40, at 33 n.75.
281. *Id.* at 33.
282. *Id.*
283. Schwartz, Baxter & Ryan, *supra* note 279, at 326.
284. *Id.* at 328; *Inefficient Norms*, *supra* note 35, at 1739–40.
285. Ellickson, *supra* note 40, at 23.
286. *Id.*

protecting property rights in the hunting grounds.[287] This change in norms is consistent with the evolutionary theory in which parties tend toward the adoption of more efficient practices over time.[288]

Norms can also become dysfunctional over time due to "group composition" dynamics.[289] For example, the norm in a particular law school may evolve away from intense use of the Socratic method and toward the use of PowerPoint displays. Although much evidence suggests that the new norm may be inefficient or less beneficial than it appears, it may arise due to student demand that professors teach them black letter rules. Another unhelpful norm that might arise in legal academia is the trend toward the publication of many small articles that are narrow in scope rather than larger, interdisciplinary pieces. Such an unhelpful norm may arise because the rewards for frequent publication outweigh concerns for quality or scholarly impact. A third such norm might arise in favor of pursuing teaching to the exclusion of scholarship.

The dysfunctional norms could be changed by decanal pronouncements in favor of the Socratic method and a faculty-implemented reward system geared toward more thoughtful scholarship requiring longer gestation periods. The third norm could be countered by a reward system incentivizing scholarship or by hiring productive, young scholars who would shift the norm toward a more scholarly orientation.[290] Dysfunctional norms can also arise due to "perverse reputational cascades"[291] in which parties like fashionistas derive income or reputation from encouraging others to buy the latest fashions. This phenomenon is due to change agents "pursuing ephemeral personal gains."[292] An inefficient norm may arise, but one would think that if it were highly inefficient, a corrective force would upset it.

The occurrence of norms like smoking may have increased as a result of the fashionable associations between smoking and movie stars. When such dysfunctional norms persist, the government can seek to change them by acting as a change agent. Private parties can become norm entrepreneurs as well as enforcers,[293] sanctioning those who smoke in public. The government can also intervene by pursuing change through publicity, such as the Surgeon General reports documenting the illnesses caused by smoking.[294] Thus, information can be promulgated to counteract a bad norm. In addition, state and municipal governments have acted to ban smoking in public.[295] Those laws were in response to the transactional impediments to allocating space between smokers and non-smokers.[296]

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287. *Id.*; Harold Demsetz, *Toward A Theory of Property Rights,* 57 AM. ECON. REV. 347, 352–53 (1967).

288. Ellickson, *supra* note 40, at 8.

289. *See id.* at 24 (discussing how changes in group membership can lead to changing norms).

290. *Id.*

291. *Id.* at 34.

292. *Id.* at 35.

293. *Id.* at 28.

294. Ellickson, *supra* note 40, at 41.

295. *E.g.*, Robbie Brown, *In the Tobacco-Rich South, New Limits on Smoking*, N.Y. TIMES, July 21, 2012, at A14, *available at* http://www.nytimes.com/2012/07/21/us/atlanta-curbs-smoking-part-of-southern-wave-of-bans.html?_r=0.

296. *See* Ellickson, *supra* note 40, at 28–29, 38, 40 (explaining that the amassing of new information about the health risks of first- and second-hand smoke led medical researchers and public health officials to emerge as norm entrepreneurs and society to become more hostile towards those smoking in their presence and establishments).

CONCLUSION

Traditionally, economics was not interested in norms as this discipline was indifferent to the way parties acquired preferences. It assumed that people took the information provided to them by the market and made choices based on expected utility. Law shared this disinterest as it assumed that parties would perceive law as an exogenous given and obey laws because of the coercive power of the state. Gradually, economists and lawyers became interested in norms because they recognized their effects on parties' behavior and choices. Analyzing norms and human behavior that predate markets and states allows analysts to understand how parties could cooperate in a non-market setting and how norms might help foster exchanges in other settings, including markets. Additionally, scholars may then understand how norms bring order even without a coercive state as well as how informal enforcement of norms, as institutions, might actually make markets and other institutions work better than if the law operated without such informal constraints. By studying how private parties bring order despite the absence of a coercive state and the idea of a norm as the result of an exchange, one can better understand how modern states, private agreements, public laws, and market economies work in conjunction with the norms and human behavior patterns that underlie all communities. These institutions of norms, public law, private law and agreements, the state, and markets are all alternative and complementary ways of (and sometimes substitutes for) addressing the same problem of social ordering to maximize welfare. Understanding that norms and their functions may shift, and therefore, that the relative role played by norms, public law, private law, markets, and institutions may also evolve to serve those underlying needs in changed circumstances presents an issue for comparative institutional analysis at a micro level.