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Second-Best Theory and Law & Economics: An Introduction

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SECOND-BEST THEORY AND LAW & ECONOMICS: AN INTRODUCTION

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According to The General Theory of Second Best,[1] if one or more members of a set of optimal conditions cannot be fulfilled, there is no general reason to believe that fulfilling (or more closely approximating) more of the remaining conditions will bring you closer to the optimum than fulfilling fewer of the remaining conditions. Second-Best Theory has startling implications for law-and-economics analysis. Most importantly, it undermines the standard law-and-economics assumption that any policy or choice that reduces the number or magnitude of the Pareto imperfections[2] in the economy will on that account increase "allocative efficiency":[3] because two Pareto imperfections can counteract each other, one cannot assume without further argu-

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1. For the first formal statement of The General Theory of Second Best (and the first use of this name), see R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956).

2. Welfare economics delineates seven (arguably eight) conditions whose fulfillment guarantees Pareto optimality. The statement that an economy is Pareto optimal in the pure sense indicates that, even if no transaction costs would have to be incurred to reallocate resources, it would be impossible to reallocate resources in a way that would make somebody better off without making anyone else worse off. The statement that the economy is Pareto optimal in the impure and somewhat inaccurate sense in which I am using (and virtually all economists in practice use) this expression indicates that, even if no transaction costs would have to be incurred to reallocate resources, it would be impossible to effectuate a reallocation that would give its beneficiaries the equivalent of more dollars than it would take away from its victims. The Pareto-optimal conditions are (1) no monopoly, (2) no monopsony, (3) no externalities, (4) no taxes on the margin of income, (5) individual sovereignty, (6) no failures to maximize, and (7) no problems caused by consumer surplus or its analogues (usually misdescribed as "no public goods"). The eighth arguable condition is that no transaction costs need be incurred to fulfill the other seven conditions. This Article uses the expression "Pareto imperfection" to refer to any departure from one of the basic seven Pareto-optimal conditions.

3. I substitute "allocative-efficiency" analysis for the standard term "economic-efficiency" analysis to remind readers that the concept is a technical term and that one cannot assume that choices that increase allocative efficiency are either desirable from any legitimate personal-ultimate-value perspective or consistent with our rights-commitments. In any event, in my terminology, a choice is said to increase or decrease allocative efficiency if the equivalent-dollar gains it confers on its beneficiaries exceed the equivalent-dollar losses it imposes on its victims. For a critique of the standard economic definition and use of the concept of the effect of a choice on allocative efficiency, see Richard S. Markovits, *A Constructive Critique of the Traditional Definition and Use of the Concept of "the Effect of a Choice on Allocative (Economic) Efficiency": Why the Kaldor-Hicks Test, the Coase Theorem, and Virtually All Law-and-Economics Welfare Arguments Are Wrong*, 1993 U. ILL. L. REV. 485 [hereinafter Markovits, *Constructive Critique*].

ment that a situation in which there are fewer or smaller Pareto imperfections will be more allocatively efficient than one in which there are more or larger Pareto imperfections. More specifically, The General Theory of Second Best demonstrates that (1) the fact that "perfect competition among sellers and buyers" are Pareto-optimal conditions does not imply that policies that increase competition will tend to increase allocative efficiency on that account in a still-Pareto-imperfect world; (2) the fact that "no externalities" is a Pareto-optimal condition does not imply that policies that internalize externalities will tend to increase allocative efficiency on that account in a still-Pareto-imperfect world; (3) the fact that "no taxes on the margin of income" is a Pareto-optimal condition does not imply that policies that reduce taxes on the margin of income will tend to increase allocative efficiency on that account in a still-Pareto-imperfect world; (4) the fact that individual "sovereignty" and "maximization" (no human errors) are Pareto-optimal conditions does not imply that policies that increase the information available to human actors (e.g., by indicating the contents and nutritional value of food-products) or reduce the probability that they will do their maths wrong (e.g., by indicating the price per ounce of food-products) will tend on those accounts to increase allocative efficiency in a still-Pareto-imperfect world; or (5) the fact that "no buyer surplus" is a Pareto-optimal condition does not imply that policies that allow sellers to convert buyer surplus into seller surplus or that government grants that offset such surplus will tend on that account to increase allocative efficiency in a still-Pareto-imperfect world.

Second-Best Theory also undermines the way in which those law-and-economics scholars who make their overall evaluation of a policy depend on its distributional consequences[4] evaluate the distributional desirability of a policy or choice (rights-considerations aside). In particular, Second-Best Theory demonstrates that

    (1)   because a distributional imperfection whose elimination would have been desirable from the relevant value-perspective were it the only distributional imperfection in the economy is as likely to have counteracted the net distributional distortion

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4. Many law-and-economics scholars have operated on the assumptions that (1) any policy or choice that increases allocative efficiency is desirable overall and consistent with our rights-commitments and (2) any policy or choice that decreases allocative efficiency is undesirable overall and not required by our rights-commitments. Both these assumptions are incorrect. *See* Markovits, *Constructive Critique, supra* note 3; Richard S. Markovits, The Relevance of Economic-Efficiency Conclusions for Moral-Ought, Moral-Rights, and Legal-Rights Analysis (unpublished manuscript on file with author, 1996) [hereinafter Markovits, Economic-Efficiency Relevance].

generated by the other distributional imperfections in the system as to have compounded it,

(2) the elimination or reduction of an individual distributional imperfection cannot be assumed without further argument to improve the distributional desirability of the society's allocation of resources from that value-perspective.

In addition, Second-Best Theory has implications for the design of decisionmaking institutions. Assume that one could define an organizational structure, a set of organizational-finance arrangements, a set of personnel-recruitment and personnel-retention policies, a set of institutional-outsider participation-rights, a set of individual-decisionmaker decision-standards, and an institutional-voting procedure that would enable the institution to maximize its "output" (given the constraints imposed by our society's rights-commitments). Because, in practice, one will not be dealing with institutions whose only imperfection is the imperfection one is in a position to reduce or eliminate and an imperfection in one of the above arrangements may counteract the net effect of the other imperfections in the institution, Second-Best Theory demonstrates that one cannot assume without further argument that a policy that eliminates or reduces one institutional imperfection will improve the functioning of the institution in question.

Finally, Second-Best Theory raises the possibility that it might be allocatively efficient, desirable overall, or rights-required to instruct the imperfect decisionmakers who are currently operating in our imperfect decisionmaking institutions to take approaches to the issues they must resolve that would not be ideal if they and their institutions were first-best perfect.[5]

5. This issue has important jurisprudential implications. Assume that there is a first-best way to analyze the moral rights or legal rights of an individual. If the personnel assigned the role of executing the relevant rights-analysis or the institutional framework within which they are operating are not "first-best" ideal (see the text *infra*), would these facts justicize (render just) changing the approach that the relevant decisionmakers are instructed to take to the rights issues they must decide if their use of such a non-first-best approach would increase the accuracy of their decisions (in some difficult-to-specify sense)? For example, if the first-best way for constitutional-rights decisions to be made were to adopt an approach in which "arguments of moral principle" were dominant but Supreme Court justices were not selected through an ideal process and were not given enough time to analyze individual cases, might a highly-imperfect analytic approach such as some form of strict constructionism be a third-best (see *infra*) response to these latter two imperfections and, if it were, would this fact justicize the use of this imperfect analytic approach? I doubt that strict constructionism or any other imperfect approach to legal analysis would improve judicial decisions from a rights perspective. However, I must admit that, even if I were convinced to the contrary, I would be reluctant to conclude that that fact would justicize the use of such an imperfect analytic approach. This reluctance may reflect my belief that in this situation a rights-based society is obligated to change its personnel-recruitment practices and other features of the relevant adjudicative institution's design to make the "first-best" analytic approach third-best as well. For a detailed analysis of my claim that arguments of moral princi-

The articles in this Symposium focus almost exclusively on the implications of Second-Best Theory for allocative-efficiency prediction.[6] On the positive side, they point out some or many of the ways in which the analysis of the allocative efficiency of particular contract-law doctrines, tort-law doctrines, health-and-safety regulations, public-utility regulations, and environmental taxes must be altered to take Second-Best Theory into account. On the negative side, they explicitly describe or implicitly reveal the failure of virtually all extant analyses of the allocative efficiency of the doctrines and rules in question to deal adequately or at all with the problems Second-Best Theory highlights.[7]

Virtually all law-and-economics scholars (indeed, virtually all economists) have responded in one of two unsatisfactory ways to The General Theory of Second Best. The overwhelming majority have either ignored the theory or denied its validity and proceeded on the assumption that any choice that decreases the number or magnitude of Pareto imperfections will tend on that account to improve resource allocation. I use the acronym "FBLE" to stand for the type of first-best-allocative-efficiency analysis that adopts this assumption because "FBLE" resembles the word "fable" and these analyses are based on the "fable" that a decrease in a particular Pareto imperfection necessarily increases allocative efficiency (or that the imperfection on which the analyst is focusing is the only imperfection in the system).

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ple are the dominant form of legitimate legal argument in our culture, see RICHARD S. MARKO-VITS, MATTERS OF PRINCIPLE: LEGITIMATE LEGAL ARGUMENT AND CONSTITUTIONAL INTERPRETATION (forthcoming New York University Press, Aug. 1998). *See also* Markovits, Economic-Efficiency Relevance, *supra* note 4.

6. I hasten to add that I do not think that allocative-efficiency analysis is an algorithm for the generation of right answers to most common-law, Constitutional, or statutory rights-questions, though some statutes may promulgate an allocative-efficiency test of legality and the internally-right answer to some moral-rights-related common-law and Constitutional questions may be the answer that maximizes allocative efficiency. *See also* Markovits, Economic-Efficiency Relevance, *supra* note 4.

7. Three of the contributions to this symposium explicitly point out the fact that the extant literature on the topics they explore largely ignores Second-Best Theory. See Thomas S. Ulen, *Judgment and the General Theory of Second Best in Law and Economics*, 73 CHI.-KENT L. REV. 189, 191 (1998); Andrew P. Morriss, *Implications of Second-Best Theory for Administrative and Regulatory Law: A Case Study of Public Utility Regulation*, 73 CHI.-KENT L. REV. 135, 136-37 (1998); Richard S. Markovits, *The Allocative Efficiency of Shifting From a "Negligence" System to a "Strict Liability" Regime in Our Highly-Pareto-Imperfect Economy: A Partial and Preliminary Third-Best Allocative-Efficiency Analysis*, 73 CHI.-KENT L. REV. 11, 23 (1998). Although the fourth article's discussion of the literature on the topic it addresses does not make this point explicitly, it reveals the failure of the literature to take adequate account of Second-Best Theory. *See* Don Fullerton & Gilbert E. Metcalf, *Environmental Taxes and the Double-Dividend Hypothesis: Did You Really Expect Something for Nothing?* 73 CHI.-KENT L. REV. 221 (1998).

A few economists have rejected such FBLE analysis in favor of general-equilibrium models that determine the most-allocatively-efficient policy-response to one or more specific Pareto imperfection(s). These economists assume that the economy (1) contains a small number of other imperfections that can be accurately and costlessly determined and (2) uses resources in only one or two different ways. Such highly-unrealistic, incomplete general-equilibrium analyses can provide many useful insights. However, given that, in reality, (1) Pareto imperfections abound, (2) data and analysis are inevitably inaccurate and costly, and (3) resources are used in a great many different ways, it would not be allocatively efficient (even if it were feasible) to use a complete version of this general-equilibrium approach to determine the most-allocatively-efficient response to a particular Pareto imperfection. I call the complete version of this general-equilibrium approach "second-best-allocative-efficiency analysis." "SBLE" is an appropriate acronym for this approach because SBLE resembles the word "sable," which signifies a beautiful object that is prohibitively expensive, and SBLE analysis would be prohibitively expensive even if it were doable, given the imperfectness of the economy, the multiplicity of resource uses, and the inevitable cost and inaccuracy of both data and analysis.

Virtually no economists or law-and-economics scholars have given significant thought to the type of allocative-efficiency analysis that would be efficient to employ in our worse-than-second-best world, in which (1) Pareto imperfections are pervasive, (2) resource-use types are multiplicious, and (3) data and analysis are costly and inaccurate. I use the acronym "TBLE" to stand for the type of "third-best-allocative-efficiency" analysis that would be *ex ante* allocatively efficient in such a worse-than-second-best world. TBLE analysis differs from SBLE analysis in that it considers the inevitable cost and inaccuracy of data and analysis when deciding how many resources to allocate to collecting data and analyzing their significance. TBLE is an appropriate acronym for this type of analysis because it resembles the word "table" and TBLE analysis is the type one should bring to the policy-evaluation table.[8]

If Second-Best Theory has critical implications for the proper approach to allocative-efficiency analysis, why have law-and-economics

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8. For a partial and preliminary TBLE analysis, see my contribution to this symposium. Markovits, *supra* note 7.

scholars and various other sorts of economists chosen to ignore it? I can offer nine partial explanations.

First, some of the relevant scholars ignore Second-Best Theory because they are understandably reluctant to face up to or admit their errors. Second, some fail to take account of Second-Best Theory because they do not want to tool up to put themselves in a position to execute TBLE analyses. Third, some mathematical economists who are willing to execute partial SBLE analyses refuse to adopt the third-best approach that Second-Best Theory really commends because they find it aesthetically unpleasing and intellectually dubious to ignore theoretical interdependencies that one has established and to base conclusions on the kinds of highly-imperfect data and guestimates that will often be third-best-allocatively-efficient (TBLE) to employ. Fourth, many applied economists and law-and-economics scholars ignore Second-Best Theory because they fear that it will lead governments to decrease allocative efficiency by intervening in the economy more often via more selective policies—i.e., to intervene in situations in which interventions would be allocatively efficient and/or overall desirable if government decisionmaking institutions and decisionmakers were first-best ideal but (they believe) will in practice be allocatively inefficient and/or undesirable overall, given the government's actual imperfections. Fifth, many economists choose to disregard Second-Best Theory because they fear that the more interventionist government they believe it favors will make rights-violating choices the theory does not recommend. Sixth, many law professors and an increasing number of economists ignore Second-Best Theory because they like clear bottom lines and correctly perceive that TBLE analysis will often lead to conclusions that are fact-dependent and, on that account, contestable. Seventh, many law professors and an increasing number of economists refuse to take Second-Best Theory into account because they want to have policy influence, realize that second-best and third-best arguments are more difficult to comprehend than first-best arguments appear to be, and believe that the "policy audience" lacks the inclination and patience to follow TBLE arguments. (These scholars may also fear [unjustifiably] that the policy audience lacks the intelligence or intellectual sophistication to comprehend such arguments.) Eighth, many law professors who address issues whose analysis should be at least partially economic ignore Second-Best Theory because they reject all allocative-efficiency analysis: these scholars have been turned off economics by the philosophically-naive claim of many economists that public

choices should be assessed solely in terms of their allocative efficiency and have failed to appreciate that, in combination with personal-ulti-mate-value analysis and rights analysis, allocative-efficiency analysis can make a valuable contribution to the evaluation of public (and pri-vate) choices from both moral-rights perspectives and some personal-ultimate-value perspectives. Ninth and finally, many economists and legal academics who study law-and-economics questions have been deterred from taking Second-Best Theory seriously by the difficulty of publishing articles or books that give it adequate consideration: most pure economics journals have page-constraints that preclude authors from developing the relevant second-best and third-best theory and justifying it by investigating a real problem in illuminating detail; although the law-and-economics journals have less severe page-con-straints, they have tended to be run by Chicago economists, who have both personal professional and ideological reasons to ignore Second-Best Theory; economics journals, law-and-economics journals, and university presses use peer-review systems, which give a crucial role to scholars who are likely to be hostile to SBLE and TBLE analysis; and student-run law reviews are edited by individuals who do not have the expertise to evaluate the importance of Second-Best Theory them-selves, do not like to ask people who are not members of their Review to assess the submissions they receive, virtually always ask law profes-sors for advice in the rare cases in which they do seek "outside" coun-sel, and are, in any case, very much creatures of fashion.[9]

Obviously, few law-and-economics scholars are influenced by all nine of the considerations just listed. However, these factors do seem to account for the failure of the overwhelming majority of such schol-ars to give Second-Best Theory the consideration it deserves. Clearly, none can provide a basis for a justification of the refusal of economists and law-and-economics scholars to restructure their work in the way that Second-Best Theory demonstrates is necessary.

My experience in organizing this Symposium both confirms the continuing refusal of talented law-and-economics scholars to take Sec-ond-Best Theory into consideration and provides some basis for opti-mism that the relevant attitudes and practices are on the verge of

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9. However, the *Chicago-Kent Law Review* is a tremendous improvement on the norm by combining aspects of a student-run journal with a peer-review journal. In conjunction with an oversight committee of three faculty members, the law review editorial board chooses sympo-sium topics based on proposals submitted to the *Law Review*. Once the symposium topic has been approved by the students and the faculty oversight committee, the symposium editor is responsible for soliciting authors to participate in the symposium.

changing. Several of the highly-respected law-and-economics scholars whose participation I sought responded by saying that they knew nothing about Second-Best Theory and had no desire to learn about it or respond to it. Two potential participants responded by articulating the theory accurately, pointing out that the profession has chosen to ignore it, and stating that they saw no reason to depart from the professional "norm." On the other hand, not only the contributors to this symposium but also several others who had outstanding obligations that precluded their participation responded to my invitation by saying (in essence): "It's about time that Second-Best Theory be given this type of attention. The General Theory of Second Best must be made the linchpin of all allocative-efficiency analyses." I hope that this Symposium persuades you that this conclusion is correct.