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EFFICIENCY AND EQUITY: WHAT CAN BE GAINED BY COMBINING COASE AND RAWLS?

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For decades, one of the most constant criticisms of the economic analysis of law has been that it fails to address distributive justice concerns. The critics say that this failure, in combination with the seemingly single-minded commitment of law and economics to efficiency as a (or *the*) legal norm, places law and economics well outside the law's long-standing and deep commitment to justice. Moreover, according to the critics, the field is out of step with society at large, which, through both norms and laws, seems far more committed to fairness and equity than to efficiency.

Heretofore, law and economics scholars have sought to address these criticisms by alleging that efficiency is and long has been a (or even *the*) dominant concern of the common law;¹ that equity is not a coherent concept or one upon which there is, in any given instance, widespread agreement;² that law and economics' concentration on efficiency is dictated by underlying microeconomic theory and not by an evaluation that efficiency is necessarily a superior value to equity;³ and that, in

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1. See, e.g., Richard A. Posner, *Economic Analysis of Law* 27–29, 271–75 (5th ed. 1998). The suggestion that the common law process gives rise to efficient legal rules was developed in John C. Goodman, *An Economic Theory of the Evolution of Common Law*, 7 J. Legal Stud. 393 (1978), George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. Legal Stud. 65 (1977), and Paul H. Rubin, *Why Is the Common Law Efficient?*, 6 J. Legal Stud. 51 (1977). That suggestion is criticized in Robert D. Cooter & Lewis Kornhauser, *Can Litigation Improve the Law Without the Help of Judges?*, 8 J. Legal Stud. 139 (1980), and Gillian K. Hadfield, *Bias in the Evolution of Legal Rules*, 80 Geo. L.J. 583 (1992).

2. See Frank H. Easterbrook, *The Supreme Court, 1983 Term: The Court and the Economic System*, 98 Harv. L. Rev. 4 (1984). That article was criticized in Laurence Tribe, *Constitutional Calculus: Equal Justice or Economic Efficiency?*, 98 Harv. L. Rev. 592 (1985). Easterbrook replied in Frank H. Easterbrook, *Method, Result, and Authority: A Reply*, 98 Harv. L. Rev. 622 (1985).

3. See Robert D. Cooter & Thomas S. Ulen, *Law and Economics* 104–06 (2d ed. 1997).

reality, little difference exists between efficiency and traditional, justice-based analyses of legal rules and institutions.⁴

Professors Swygert and Yanes take a different tack.⁵ They seek to bring efficiency and equity to bear explicitly on the economic analysis of law by merging Rawlsian social contract philosophy into law and economics' basic premise, the Coase Theorem. We are in complete agreement with Swygert and Yanes that good legal policy should be concerned with both efficiency and equity, and we welcome their attempt to merge the two as a useful step in an important debate. Ultimately, though, we are unconvinced by their argument as it currently stands for two reasons. First, by focusing only on the way in which their approach might affect how the law regulates the exchange of goods or legal entitlements (i.e., contract law), the authors provide no explanation of how their approach could be used to determine the initial allocation of goods and legal entitlements (i.e., property law). If legal policy is to take equity as seriously as efficiency, it is critical that equity be considered when legal entitlements are assigned, not merely when parties choose to trade their entitlements. Consequently, the omission of any discussion of how entitlements might be initially assigned under the authors' proposed theoretical framework is of critical importance.

Second, the authors' argument for jointly considering equity and efficiency when legal rules are developed is severely flawed. It rests on an unrealistic empirical premise—that all classes of entitlement

4. This is the thrust of much of the conventional law and economics of property, contract, and tort law. For example, one might well argue that it is efficient to compensate property owners when the government physically takes their property because that rule generally induces both private parties and the government to make efficient land-use decisions. But one could just as easily argue that the compensation requirement does justice to the private property owner. On the economic analysis of taking and regulatory taking, see Cooter & Ulen, *supra* note 3, at 149–55. On the general comparison between efficiency and fairness analyses of law, see Posner, *supra* note 1, at 30–31. See also Symposium, *Efficiency as a Legal Concern*, 8 Hofstra L. Rev. 485 (1980); *Debate: Is Law and Economics Moral?*, 24 Valparaiso L. Rev. 147 (1990). There are, of course, instances in which efficiency and traditional analyses of legal rules reach different conclusions. For instance, one of us has argued that the efficiency of contracting and of the resolution of contractual disputes would be more efficient if specific performance were the routine remedy for breach of contract. Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 Mich. L. Rev. 341 (1984). Neither all or even most law and economics scholars agree with that position. The traditional view is, of course, that money damages should be the routine remedy for contract breach. Importantly, where this and other differences between efficiency and equity exist, very few followers of law and economics categorically assert that the efficiency analysis should prevail.

5. Michael I. Swygert & Katherine Earle Yanes, *A Unified Theory of Justice: The Integration of Fairness into Efficiency*, 73 Wash. L. Rev. 249 (1998).

claimants are equally wealthy, on average—and it fails to take account of the negative efficiency consequences that are likely to follow from the operationalization of their approach. Because of such negative consequences, a legal regime ultimately concerned with efficiency and equity might be better off with rules of private law that focus entirely on providing incentives for individuals to maximize the efficient use of resources followed by a tax-and-transfer system to redistribute goods and entitlements equitably *ex post*. Most legal economists implicitly or explicitly prefer such a “two-step” approach to efficiency and equity over any “single-step” approach.⁶ While conventional wisdom does not always equate with foolproof reasoning, Swygert and Yanes must, at a minimum, provide a reason for preferring that equity be provided concurrently with, rather than subsequent to, efficiency.

In this response to Swygert and Yanes, we undertake three principal tasks. First, we attempt to highlight the insights in the authors’ argument that are novel and important to the debate on allocating entitlements and policing their transfer. Second, we attempt to expand their analysis by developing a theory of how property rights could be allocated consistent with Swygert and Yanes’s dual focus on efficiency and equity. We call our theory the “market contrarian” approach to entitlement allocation. Third, we address the negative consequences of combining the goals of efficiency and equity in the creation of rules of property and contract law and explain why the traditional “two-step” approach favored by law and economics scholars might be superior. Here we rely on the Second Theorem of Welfare Economics.⁷ Finally, we offer concluding remarks on the future of equitable considerations in law and economics.

I. INTEGRATING EFFICIENCY AND EQUITY

The Coase Theorem stands for the proposition that when transaction costs (the costs of affecting an exchange) are zero, bargaining will result

6. See, e.g., Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. Legal Stud. 667 (1994); Steven Shavell, *A Note on Efficiency vs. Distributional Equity in Legal Rulemaking: Should Distributional Equity Matter Given Optimal Income Taxation?*, 71 Am. Econ. Rev. 414 (1981).

7. The Second Theorem—or the Second Fundamental Theorem—of Welfare Economics, which we discuss more fully below in Part III.A, holds that, in competitive markets, efficiency and equity are separable. The implication is that society need not use a single policy instrument to achieve its efficiency and distributive goals. Rather, separate policy instruments can independently seek to achieve societal goals with respect to the efficient allocation of resources and the equitable distribution of income and wealth.

in an efficient allocation of resources regardless of the assignment of legal rights and obligations.⁸ Costless bargaining should allow the parties to whom a right or obligation is most valuable to purchase it (if they do not have it initially) or retain it (if they already happen to have it). Thus, the initial assignment of legal rights and obligations does not matter to the efficient use of resources.⁹ The assignment of rights does, however, affect wealth and income positions. The person to whom the initial assignment is made will be wealthier than if he did not initially have the right, either because he can enjoy it without having to first purchase it or because he can sell it and use the proceeds to acquire other entitlements that he would prefer.¹⁰

Swygert and Yanes focus their attention on the failure of the Coase Theorem to take account of equity in its implicit suggestions for establishing legal rules to govern private contracting in situations where one individual values a good or a legal entitlement more than its original owner.¹¹ The authors would address this inattention by incorporating the notion of the Rawlsian veil of ignorance (what Swygert and Yanes call the “condition of hidden identity”) into the circumstances in which the Coase Theorem is relevant—at least in contract law.¹² To accomplish this modification, they suggest asking bargaining parties what legal rules they would prefer to govern private contracts *if they did not know on which side of the potential bargain they would, in fact, stand*.¹³

In what way would this approach lead to different legal rules than those that emanate from traditional law and economics scholarship?

8. R.H. Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1, 6 (1960).

9. See Cooter & Ulen, *supra* note 3, at 79–93 (discussing Coase Theorem).

10. Professor Coase contends that the initial assignment does *not* affect income and wealth positions when transaction costs are zero because each party will have discounted the value of holding the entitlement to reflect the likelihood of exchanges and other future changes. See Ronald Coase, *The Firm, the Market, and the Law* 170–74 (1988).

11. The offending inattention to equity arises only in bargains having to do with *fundamental* legal rights and obligations. By this friendly amendment to Professors Swygert and Yanes’ proposal, we mean to suggest that no one cares deeply about the division of a cooperative surplus between a green-grocer and a purchaser of onions, but they do care about the meta-rules of surplus division in contractual relations, real property transactions, bargains for the potential waiver of fundamental constitutional rights, employer-employee relationships, and similar situations.

12. We assume that there is no dispute between Professors Swygert and Yanes and law and economics scholars about the appropriate circumstances in which to apply the Coase Theorem. That is, we all seem to agree that the Coase Theorem is to be used, if at all, in settings of zero transaction costs.

13. Swygert & Yanes, *supra* note 5, at 314–16.

Given an initial allocation of entitlements and zero transaction costs, the Coase Theorem favors the enforcement of any voluntary exchange. The problem with such a regime, according to Swygert and Yanes, is that when one party to a transaction is stronger (i.e., has market power), she can co-opt “almost all of the surplus utility created by the transaction,” even when the transaction is wealth-maximizing and both parties are benefited by it.¹⁴ According to the authors, the appropriate response to such efficient but inequitable transfers is to use legal rules to force the parties to divide the gains in trades created by such bargains equally.

The doctrine of unconscionability is perhaps the most understandable example offered by Swygert and Yanes of how to operationalize this principle. In the standard casebook example of the doctrine, *Williams v. Walker-Thomas Furniture Co.*,¹⁵ a retail store imposed a cross-collateralization payment clause in a consumer credit contract that gave the store the right to repossess *all* items purchased on credit by a customer if the customer missed a payment prior to paying off its balance on *each one* of the items.¹⁶ The court found the contract potentially “unconscionable” and therefore not enforceable.¹⁷ Swygert and Yanes call this conclusion defensible “under a pure fairness approach” (although they do not elaborate on—and it is not obvious—why this is the case).¹⁸ They suggest that the case should be decided by asking what resolution the parties would favor if they understood the facts of the case but did not know whether they were the consumer or the merchant.¹⁹ With the qualification that their opinion is tentative, the authors suggest that the transaction should be permitted but the terms most onerous to the consumer disallowed.²⁰

It is not at all clear to us why Swygert and Yanes believe that parties to the transaction, without knowing which party they are, would favor such a resolution. But we believe the following arguments lead to their conclusion. First, individuals experience a declining marginal utility for money; that is, they gain more pleasure from their first dollar than from

14. *Id.* at 14.

15. 350 F.2d 445 (D.C. Cir. 1965); see Cooter & Ulen, *supra* note 3, at 253–55 (discussing *Williams*).

16. *Williams*, 350 F.2d at 447.

17. *Id.* at 450.

18. Swygert & Yanes, *supra* note 5, at 317–19.

19. *Id.* at 319.

20. *Id.*

their second dollar, from their second dollar than their third, and so on. Second, because of the declining marginal utility for money,²¹ people tend to be risk averse in financial matters; that is, they would prefer a certainty of one dollar to a fifty percent chance of gaining two dollars coupled with a fifty percent chance of gaining zero dollars, even though both choices have the same expected value of one dollar. Third, without knowing whether they are the buyer or the seller in a given transaction, risk-averse individuals would prefer an approximately fifty percent share of the cooperative surplus created by the transaction rather than a fifty percent chance of gaining virtually all the surplus (if they turn out to be the retailer with the strong bargaining position) and a fifty percent chance of gaining virtually none of the surplus (if they turn out to be the consumer with little bargaining power). Finally, the authors' proposed resolution of the case assigns—in a rough kind of way—approximately half of the cooperative surplus to each party.

This analysis suggests a few observations about Swygert and Yanes's approach that go unstated by the authors. First, although Swygert and Yanes consistently refer to a "fairness" norm, their approach is rooted in utilitarianism. That is, they ultimately seek to justify their redistributionist approach to contract law by implicitly claiming that it would maximize the joint utility of the parties to a transaction, viewed from the *ex ante* position. Second, the key insight that drives their conclusions is that individuals are risk averse. Their policy recommendations, it turns out, do not depend directly on the Coase Theorem or the Rawlsian veil of ignorance, but on the far simpler claim that equally distributing the gains to be captured by Pareto-efficient transactions maximizes social utility.²² Third, for their analysis to be correct, the authors must assume that all parties to Pareto-efficient transactions are equally wealthy prior to the transaction, at least on average. If consumers subject to cross-collateralized credit agreements tend to be poorer on average than retailers that impose such terms, and both consumers and retailers are subject to the declining marginal utility of money, the law might maximize social utility by granting the lion's share of any cooperative surplus to the consumers. To put the point into

21. That is, most individuals are risk averse. For a discussion of the connection between one's marginal utility of income or wealth and one's attitudes toward risk, see Cooter & Ulen, *supra* note 3, at 44–48. See also Russell Korobkin, *Determining Health Care Rights from Behind a Veil of Ignorance*, 1998 U. Ill. L. Rev. (forthcoming).

22. An exchange or reallocation is "Pareto efficient" if it makes no party worse off and at least one of the parties better off. See Cooter & Ulen, *supra* note 3, at 12.

terms that Swygert and Yanes use, if the parties to such a transaction knew the *ex ante* wealth distribution between consumers and retailers but did not know which party they would be, risk aversion might well suggest that they would favor a distribution of the surplus that favored the poorer party. That it is almost certainly true that consumers and retailers are *not* equally wealthy *ex ante* highlights an important failure of Swygert and Yanes's theory, a point to which we return later.²³

II. EXPANDING THE EQUITY/EFFICIENCY DUALISM TO PROPERTY RULES: THE "MARKET CONTRARIAN" APPROACH

The premise that motivates Swygert and Yanes's argument is that the rules of private law should take account of equity concerns in addition to the efficiency concerns that drive most law and economics analysis. But their analysis considers only how this concern should affect the policing of private transactions given some exogenously determined baseline set of entitlements. That is, their argument addresses only the rules of contract law.²⁴ They ignore the question of how legal rules should initially assign legal rights between competing claimants. Their discussion of nuisance law, for example, completely ignores the question of whether an activity should be considered a nuisance. Instead, the analysis focuses only on the rules governing the exchange of an assumed right of neighbors to a factory to be free from noxious pollution.²⁵

The authors' failure to consider how rules of property law would be affected by a legal regime that took account of both equity and efficiency is critical for a simple reason: the law has far more power to create distributional equity through the allocation of initial entitlements than through adjusting the terms of private transactions. Consequently, in this section we present our own theory of how lawmakers could assign property rights if they wish to combine efficiency and equity concerns in their decisionmaking. We call this approach the "market contrarian" approach to entitlement allocation. We explain both how entitlements would be allocated and protected under the market contrarian approach

23. See extended discussion *infra* Part III.B.1.

24. See Swygert & Yanes, *supra* note 5, at 317–23. Actually, their analysis concentrates on how their approach would be operationalized in regard to a certain type of contract law rules: "immutable" rules. The problems with applying the authors' approach to "default" contract law rules is considered *infra* in Part III.B.3.

25. Swygert & Yanes, *supra* note 5, at 324–25.

and how this approach differs in important respects from Coase Theorem-based approaches to entitlement allocation.

A. *Allocating Entitlements Between Competing Claimants*

As a point of departure for exploring the market contrarian approach, consider a textbook example of a dispute over an entitlement (used by Coase himself²⁶ and alluded to by Swygert and Yanes²⁷): a factory that emits noxious pollution and its unhappy neighbors. The operative legal question is, “Which party or parties should have an entitlement to the shared airspace?” If the law deems the factory a nuisance, then the law effectively grants the entitlement to the neighbors, and they may either enjoin the factory’s production or sue for damages (depending on whether the law protects the neighbors’ entitlement by a “property” or “liability” rule).²⁸ If the law does not deem the factory a nuisance, then the law implicitly grants the entitlement to the factory owner, and the owner can pollute unless the neighbors pay a bribe sufficient to convince the owner to stop production (or perhaps, to hypothesize a liability rule, invoke condemnation proceedings at a court-approved price).²⁹

Law and economics analysis, relying on the Coase Theorem, has suggested two ways that lawmakers could attempt to efficiently allocate the right in question, known as the “market mimicking” and “market facilitating” approaches.³⁰ The former method calls on lawmakers to determine whether the factory would continue to operate in a world of zero transaction costs. If the answer is yes—or, in other words, if the factory owner values pollution more than the neighbors value clean air—then lawmakers should not deem the offending use a nuisance and should allocate the entitlement to the factory owner. This outcome is efficient

26. Coase, *supra* note 8, at 41–42.

27. Swygert & Yanes, *supra* note 5, at 324–25.

28. For the seminal discussion that divides remedies into classes of “property rules” and “liability rules,” see Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089 (1972). The problem is cleverly revisited in James E. Krier & Stewart J. Schwab, *Property Rules and Liability Rules: The Cathedral in Another Light*, 70 N.Y.U. L. Rev. 440 (1995). See also Symposium, *Property Rules, Liability Rules, and Inalienability: A Twenty-Five Year Retrospective*, 106 Yale L.J. 2081 (1997).

29. See *Spur Indus., Inc. v. Del E. Webb Dev. Co.*, 494 P.2d 700 (Ariz. 1972) (requiring polluter to shut down its operation near residential neighborhood, but also requiring neighborhood’s developer to pay polluter’s costs of relocation).

30. Mark Kelman, *A Guide to Critical Legal Studies* 123–24 (1987); see also Coase, *supra* note 8, at 17–18.

for one of two reasons. First, if transaction costs are low, the allocation saves the parties from incurring transaction costs to reach this assignment, which would have occurred if the law had initially assigned the entitlement to the neighbors—who, by assumption, do not value the entitlement as highly as does the factory—and they had then sold it to the factory. Second, if transaction costs are high, the allocation to the factory ensures efficiency because the higher-valuing user has the entitlement, an outcome that might not have occurred if the law required the parties to bargain. If lawmakers follow the market-mimicking approach without error, it does not matter whether the entitlement holder's right is protected with a property or a liability rule, because the non-entitlement holder will not be willing to pay the entitlement holder's asking price or a court-imposed condemnation price.

In contrast, the market-facilitating approach requires policymakers to ask which possible allocation is likely to minimize transaction costs so that the parties are most likely to bargain around the initial allocation if it turns out to be inefficient. Those favoring this approach might be more skeptical of lawmakers' abilities to determine *ex ante* which party most values the entitlement than are those favoring the market-mimicking approach. Consequently, the market-facilitating approach seeks to minimize the social costs of the lawmakers' having mistakenly assigned the initial entitlement to the lower-valuing party.

In our example of the factory and the neighbors, the market-facilitating approach would ask which transaction costs are higher: those of the factory's attempting to purchase the entitlement from the neighbors, or those of the neighbors' attempting to purchase the entitlement from the factory. In the first case, the factory may face significant hold-out problems; in the second case the neighbors may face significant free-rider problems.³¹ Lawmakers who follow the market-facilitating approach should assign the entitlement to the factory if they believe that the transaction costs of the hold-out problem are lower than the transaction costs of the free-rider problem. If they believe

31. Cf. Krier & Schwab, *supra* note 28, at 449 (noting that when it is unclear which party values entitlement most and transaction costs are asymmetric, efficiency is best served by allocating entitlement to party that will be able to trade it at lowest cost). A "hold-out problem" exists when a purchaser must get the consent of a large number of people in order to conclude a transaction. Each of those who must consent has an incentive to withhold that consent in order to get as large a fraction of the cooperative surplus from the transaction as possible. A "free-rider problem" exists when it is costly to a seller to make each of the beneficiaries from a transaction pay a proportionate share of the benefit.

the reverse to be the case, they should assign the entitlement to the neighbors. The market-facilitating approach, because it self-consciously attempts to encourage private bargaining, implicitly suggests that the entitlement, once assigned, should be protected by a property rule.

If we take seriously the notion that the rights claimants are risk averse and, therefore, would receive more utility from capturing half the cooperative surplus of a Coasean bargain than from having a fifty percent chance at capturing all the surplus and a fifty percent chance of capturing none of it, both of these traditional approaches are problematic because they fail to guarantee a division of the cooperative surplus that is optimal (or even close to optimal) from a utility-maximization perspective. The market-mimicking approach is clearly suboptimal from this perspective because the party initially awarded the entitlement captures all of the cooperative surplus. The market-facilitating approach is also suboptimal because, while the parties might divide the cooperative surplus, the allocation of the entitlement is made without concern as to whether or not there will be such a division and whether or not that division would be equitable. If the cooperative surplus is divided rather than captured by one party, the result is purely happenstance.

To illustrate these different approaches, assume that the neighbors collectively value clean air at \$2000 and that the factory owner values the right to pollute at \$3000. This yields a cooperative surplus of \$1000 that the parties might divide. Under a market-mimicking approach, the law will assign the entitlement to the factory owner, and he captures the full \$1000 surplus.³² Under the market-facilitating approach, the law might assign the entitlement to either side, depending on which allocation the lawmakers think will best facilitate bargaining. If this turns out to result from assigning the entitlement to the neighbors, there will be a division of the cooperative surplus: the factory owner should pay the neighbors something more than \$2000 but less than \$3000 for the right to pollute. But if it turns out that market-facilitation argues for assigning the entitlement to the factory owner, the owner will capture all of the cooperative surplus plus more, just as would occur under a market-mimicking approach.

32. Actually, the situation is even worse from a distributive perspective. The factory owner gains the \$1000 surplus plus an additional \$2000 that, figuratively, comes out of the pocket of the neighbors. Thus, the factory owner ends the day at +\$3000, while the neighbors end the day at -\$2000.

If we assume that individuals are risk averse and that both sets of entitlement claimants are equally wealthy (or at least on average all claimants will be equally wealthy), dividing the cooperative surplus between the factory owner and the neighbors, rather than awarding it all to the factory owner or to the neighbors, maximizes social utility. One way to ensure a division of the cooperative surplus would be to assign the entitlement *in direct contrast* to the market-mimicking approach.³³ This “market contrarian” approach, as we shall call it, requires lawmakers to assign the entitlement to the party who values it *less*, thus forcing the higher-valuing party to share the cooperative surplus—which can be created only through a trade—with the lower-valuing party.³⁴ Thus, if the law awards the entitlement to the neighbors, the factory owner must purchase the entitlement from them. In so doing, the owner must share at least some of the cooperative surplus with the neighbors.

B. *Protecting Entitlements with “Super-Liability” Rules*

As described to this point, there are two important problems with the market-contrarian approach. The practical applicability of this approach to the assignment of initial entitlements requires that lawmakers know which party values the entitlement more and what transaction costs each party faces. The second of these problems is particularly crucial. Suppose that, applying the market-contrarian approach in our example, lawmakers determine that the entitlement is worth more to the factory and, therefore, assign the entitlement to the neighbors. But suppose further that

33. Another way to achieve a division of the cooperative surplus is to divide the entitlement between the claimants. Ayres and Talley have suggested such a division, although for efficiency rather than equity reasons. They believe that divided entitlements can reduce strategic behavior in bargaining that would otherwise preclude efficient transactions. See Ian Ayres & Eric Talley, *Distinguishing Between Consensual and Nonconsensual Advantages of Liability Rules*, 105 Yale L.J. 235 (1995); Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 Yale L.J. 1027 (1995). But see Louis Kaplow & Steven Shavell, *Do Liability Rules Facilitate Bargaining? A Reply to Ayres and Talley*, 105 Yale L.J. 221 (1995) (criticizing Ayres and Talley approach); Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 Harv. L. Rev. 713 (1996) [hereinafter Kaplow & Shavell, *Property Rules*].

34. This approach seems to us to be a property-law equivalent of the argument in favor of penalty default rules in contract law. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87 (1989). A need for a special default rule arises in the contractual situation in which one of the parties has special losses from the other party's non-performance. Penalty default rules call for assigning the liability for failing to divulge those special losses to the party who would suffer them as an inducement for that party to reveal special information to the other party in the contract formation phase.

unknown to the lawmakers, the transaction costs of the factory owner's bargaining with the neighbors to acquire the entitlement are so high as to prevent a bargain's being concluded. As a result, there will be no bargain and no division of the cooperative surplus. Moreover, even if the transaction costs are low, the market-contrarian approach guarantees some sharing of the cooperative surplus between competing entitlement claimants, but it fails to guarantee that the surplus be shared equally. Both of these problems with transaction costs can be overcome by protecting market-contrarian entitlement allocations with what we call "super-liability" rules.

An entitlement is protected by a property rule when its holder has an absolute right to refuse to sell the entitlement at any price. An entitlement is protected by a liability rule when it can be taken by another without the consent of the entitlement holder, so long as the taker pays a court-determined amount of compensation for the taking.

In our example, if the neighbors' entitlement to clean air is protected with a property right, it is impossible to predict *ex ante* the precise division of the cooperative surplus gained by the neighbors' selling their right to the factory. Under a property-rule regime, either party might have superior bargaining power (for any number of reasons) that could enable it to capture the vast majority of the cooperative surplus, leaving the other with only pennies. In our example, the factory owner might succeed in paying the neighbors only \$2001 dollars, or, at the other extreme, the neighbors might force a payment of up to \$2999. Under a liability-rule regime, as usually understood, a court would set the condemnation price at \$2000, a figure that would leave the neighbors indifferent between owning the entitlement and selling it, but that would permit the factory owner to capture all of the surplus. A traditional liability rule, then, would be even less desirable than a property rule, so long as the goal is understood to be an equal division of the surplus.

A superior approach to either a traditional property or liability rule is to protect the neighbors' entitlement with a liability rule under which the condemnation price is set to divide the cooperative surplus equally. We call this a "super-liability" rule. In our hypothetical, for example, a court could permit the factory to condemn the neighbors' entitlement but set the condemnation price at \$2500 rather than \$2000, thus forcing the factory owner (who would prefer to condemn the entitlement at that price rather than leave the air clean) to split the cooperative surplus evenly with the neighbors. Super-liability rules, therefore, can best be used to promote the underlying goal of market-contrarian entitlement

allocations—the equal distribution of the cooperative surpluses between competing entitlement claimants.

We have merely sketched our market contrarian proposal here. There are many more details that need to be elaborated, but we offer it as a plausible means of assigning initial entitlements so as to incorporate both efficiency and equity concerns.

III. THE PROBLEMS WITH COMBINING EFFICIENCY AND EQUITY

Before determining whether, as Swygert and Yanes propose, the rules of private law should be designed to consider both efficiency and equity simultaneously, it is important to understand what is and what is not the primary competing position. Swygert and Yanes contend that practitioners of law and economics believe legal policy should single-mindedly pursue the goal of efficiency.³⁵ Accordingly, their proposal seeks to reform what is implicitly suggested to be a heartless body of scholarship that turns a deaf ear to matters of fairness and equity. At best, this describes the normative position of a fraction of law and economics scholars; at worst, it is an unfair caricature of the entire law and economics movement.

The hard question posed by the suggestion of merging equitable considerations with efficiency considerations in determining legal rules is not whether legal policy should concern itself with equity, but whether it makes more sense for private law to focus on maximizing the efficient use of resources and for the government to redistribute wealth later through the tax-and-transfer system. As we suggest in this section, we think that a strong case can be made—one that is not addressed by Swygert and Yanes—for separating matters of efficiency and equity. That is, there are good reasons to think a two-step approach to confronting efficiency and equity concerns is more sensible than the single-step approach. Our claim here is not conclusive, and it does not relegate Swygert and Yanes's proposal to the academic dustheap, but it suggests that their proposal is significantly underdeveloped as it stands and needs substantial reinforcement and refinement.³⁶

35. Swygert & Yanes, *supra* note 5, at 255–56 (“[L]aw and economics proponents argue that legal rules should be applied to produce the most efficient, wealth-maximizing consequences, wholly apart from empathic considerations about the parties and their relative situations.”).

36. We recognize that the criticisms we are about to make might also apply to our market-contrarian approach.

A. The Second Fundamental Theorem of Welfare Economics

Law and economics relies upon microeconomic theory for its tools of analysis. One starting place, therefore, in which to seek the roots of law and economics analysis of income and wealth distributional issues is in microeconomic theory. The most important tool for our purposes is the Second Theorem of Welfare Economics. That theorem holds, in essence, that issues of equity and efficiency are separable.³⁷ That is, different social policies can independently achieve social goals of equity and efficiency. Society need not seek to achieve both goals simultaneously through a single policy. For example, it would violate the Second Theorem to impose rent controls (i.e., maximum allowable prices charged to renters of residential properties) as a method of achieving the distributional goal of making low-income renters better off. Rather, society should allow relative prices in competitive housing markets to serve their allocative role of directing resources to their most efficient uses and then, only after a competitive equilibrium has been reached, society should implement tax-and-transfer policies to redistribute resources in line with society's distributive goals.

How might the Second Theorem apply to our concerns about entitlements and distribution? In our example of the polluting factory and its neighbors, the Second Theorem directs that the law should structure rights between factories and neighbors to assure that land is used efficiently, without consideration of any equitable concerns. The State can later take from the "winners," whoever they are, and give to the "losers," thereby satisfying equity concerns. In other words, it is far from clear that the twin goals of efficiency and equity are best served by attempting to use legal rules to divide cooperative surpluses created by individual entitlement and/or individual transactions on the spot.

We are fully aware that many plausible objections may be made to achieving efficiency first through legal rules, and equity second through redistributive policies. For example, markets are not really competitive; consumer preferences may not be convex; production processes may exhibit increasing returns to scale; tax-and-transfer policies may have an independent distortionary effect; and other market imperfections might

37. The theorem states that each Pareto-efficient allocation is a market equilibrium. There are some important technical requirements for the theorem to hold—namely, that consumer preferences are convex and that production technologies are also convex. See Hal R. Varian, *Intermediate Microeconomics: A Modern Approach* 515 (4th ed. 1996). On the separation aspect of the Second Theorem, see *id.* at 517–18.

need correcting before we can confidently assume that a market is competitive enough to be unregulated. But the important question is not whether following the dictates of the Second Theorem will lead to perfect social policy. The question is whether following the Second Theorem would be superior or inferior to adopting the Swygert and Yanes approach to dealing with efficiency and equity concerns simultaneously. In the next section we argue that, due to important problems that plague Swygert and Yanes's proposal, the results achieved by following the Second Theorem would likely be superior.

B. Questionable Assumptions and Negative Consequences

There are two reasons to be skeptical that combining efficiency and equity in the construction of contract law rules (as Swygert and Yanes have proposed) or in determining initial entitlement allocations (as we have proposed above) is likely to improve social utility, the normative measure on which Swygert and Yanes's proposal is implicitly based. The first reason is that a critical implicit assumption of the Swygert and Yanes approach—that competing rights claimants are, on average, equally wealthy *ex ante*—is almost certainly false. The second is that taking account of equity in the construction of the rules of private law would almost certainly have negative efficiency consequences that would make the dual approach less desirable to individuals located behind a veil of ignorance than Swygert and Yanes recognize. We will explain these problems in turn. Finally, we will highlight one further, but less central, shortcoming of the Swygert and Yanes approach: although it could be applied to mandatory, or immutable rules of contract law, in addition to rules of property law, it is not at all applicable to the far larger set of default rules of contract law.

1. The Equal Wealth Assumption

Suppose that the government had one dollar to allocate and two potential recipients: one a destitute, homeless person on the verge of starvation, the other a multi-millionaire. How should the government determine how to allocate the one dollar? According to Swygert and Yanes's adaptation of the Rawlsian veil of ignorance, the government ought to ask how the parties themselves would choose to allocate the dollar if they knew all the relevant facts except for their future identities. How the parties would vote in such a situation seems quite clear. They would almost certainly *not* divide the cooperative surplus evenly,

instructing the government to give each claimant fifty cents. They would allocate the entire dollar to the person on the verge of starvation.

The point of this stark hypothetical is to demonstrate that although risk aversion does suggest that parties behind a veil of ignorance would tend to favor an equal distribution of resources, they would favor equality in the *overall* distribution of resources, not necessarily in the distribution of any single resource. If individuals did not know if they were factory owners or neighbors, would they favor an equal distribution of the social surplus to be gained by permitting the factory to pollute? If individuals did not know if they were consumers or retailers, would they favor an equal distribution of the cooperative surplus to be gained from an agreement of sale? The answer to both questions is "yes" only if members of both groups are equally wealthy when the questions are asked. If neighbors and consumers tend to be poorer than factory owners and retailers, risk aversion might suggest that individuals behind a veil of ignorance would favor the majority of the social surplus to be given to the neighbors and consumers, just as they would favor giving a single dollar to the starving man rather than to the millionaire. Thus, it seems more sensible from a utilitarian standpoint to redistribute wealth from those who are rich on balance to those who are poor on balance, rather than to try to divide resources equally each time a resource is allocated or exchanged.

2. *Incentive Effects of Equal Divisions*

Equal divisions of cooperative surpluses are desirable from a utilitarian standpoint assuming (1) individuals are risk averse, (2) wealth is distributed equally, on average, between negotiating parties, and (3) the equal-division principle does not have unintended side-consequences that reduce utility. Even if assumptions one and two were realistic,³⁸ assumption three almost certainly is not. This means that the normative goal of equally dividing cooperative surpluses is not likely to maximize social utility in many instances.

The first problem with the strategy of distributing the cooperative surplus equally between parties is that, where this requires assigning entitlements in the market-contrarian fashion (to the party who values the entitlement less), the presence of significant transaction costs will prevent many efficient distributions from occurring. Even if we limited

38. As explained above, assumption two probably is not realistic.

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market-contrarian allocations to situations in which transaction costs were expected to be low—thereby ensuring that few if any entitlements would end up allocated inefficiently—the problem is not solved entirely. Even when the cooperative surplus exceeds the transaction costs so that the parties are able to reallocate an inefficient initial allocation of an entitlement, as the Coase Theorem predicts, any non-zero transaction costs incurred will reduce the parties' cooperative surplus.

Given a fixed cooperative surplus, risk aversion suggests that society can maximize its utility by dividing the surplus evenly between two parties of equal wealth. But if the method that must be used to ensure a division of the surplus reduces the surplus, it is no longer clear that even risk-averse individuals will be willing to sacrifice the required amount of social wealth for the sake of distributive equality. Everything depends on the individuals' level of risk aversion and how much cooperative surplus is consumed by transaction costs. Any time that transaction costs are non-zero (which basically means "always"), it is unclear whether the equity created by the market-contrarian approach will outweigh, in utility terms, the transaction costs associated with it.

The second problem with designing legal rules to divide cooperative surpluses achieved through Coasean bargaining is that such rules may reduce the incentives of future contracting parties to produce wealth that can then be allocated through Coasean bargains. If the factory owner knows that she must share equitably the cooperative surplus to be gained from starting a factory that pollutes, then this diminishes her incentives to collect the capital and labor necessary to build and operate such a factory.³⁹ If the retailer knows that he must share equally with the consumer the cooperative surplus to be gained from sales, then this diminishes his incentive to open the store in the first place. The result is that equal distributions represent a kind of tax on the production of resources that will dampen incentives to produce and thus result in the reduction of the total amount of social resources. If the cost of equal distributions of cooperative surpluses is that less cooperative surplus is realized through production in the first instance, it again becomes unclear whether even a risk-averse individual would be willing to suffer the costs associated with equal distributions of surpluses.

A practical problem also exists with equal division of cooperative surpluses. Legal decisionmakers would have difficulty determining

39. See Kaplow & Shavell, *Property Rules*, *supra* note 33, at 713 (claiming that it is inefficient to set condemnation payments above point at which payment would make "seller" indifferent).

accurately the size of the cooperative surplus to be divided. To return to our nuisance example, if the neighbors' right to clean air is protected by a super-liability rule, as we proposed, there is a high likelihood that judges charged with setting the appropriate condemnation price would err in their calculations.⁴⁰ It is difficult enough for judges to determine the damages suffered by a party who owns an entitlement protected by a liability rule. It would be even more difficult for judges to estimate the cooperative surplus created when a higher-valuing user of an entitlement takes the entitlement from a lower-valuing user. Consequently, the error costs associated with such an endeavor are likely to be very high.

3. *Applicability to Contract Law: Immutable Rules and Default Rules*

Contract law consist of immutable rules—rules externally imposed on private parties regardless of the parties' wishes—and default rules—rules that parties are free to ignore in favor of their mutually agreed upon rules.⁴¹ The prediction that parties are risk averse leads to an analysis of immutable contract rules that parallels our earlier analysis of rules that protect entitlement allocations. Recognizing that individuals are risk averse and assuming that buyers and sellers are, on average, equally wealthy leads to the plausible suggestion that immutable rules should be set so as to divide the cooperative surplus achieved through private contracting between the parties.

Most rules of contract law, however, are default rules that govern the relationship between contracting parties only if the parties fail to make other arrangements. For example, consider the rule of commercial impracticability, which excuses a seller from performance of her contractual obligation if unforeseen circumstances make performance "impracticable," so long as the risk was not allocated to the seller by the contract.⁴² Notice that this is a default rule, because the parties are free to contract around the rule if they wish. The Coase Theorem predicts that so long as transaction costs are low, if the seller is a better insurer of the risk of unforeseen circumstances beyond the control of either party than is the

40. Cf. A. Mitchell Polinsky, *Resolving Nuisance Disputes: The Simple Economics of Injunctive and Damage Remedies*, 32 *Stan. L. Rev.* 1075, 1079 (1980) (pointing out that assessment costs might prevent judges from making efficient damages calculations under liability rules); Krier & Schwab, *supra* note 28, at 453–54 (reinforcing Polinsky's point).

41. Ayres & Gertner, *supra* note 34, at 87; see also Symposium, *Default Rules and Contractual Consent*, 3 *S. Cal. J. Interdisc. L.* 1 (1993).

42. See Restatement (Second) of Contracts § 261 (1979).

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buyer, the parties will contract for a term that holds the seller strictly liable for all failures to perform, even when they are unforeseen and beyond her control. In this situation, the difference in the parties' abilities to insure against such events is the cooperative surplus that may be divided based on the parties' relative bargaining ability and leverage. In the situation of default rules, Swygert and Yanes's theoretical approach strikes us as impossible to operationalize and, therefore, ultimately of little value.

Swygert and Yanes's suggestion of how to consider equity and efficiency in the context of the commercial impracticability default rule, we infer, would be that the buyer and the seller who find it jointly advantageous to contract around the commercial impracticability rule should determine how to split the surplus as if they did not know which party was the buyer and which was the seller. Whatever might be said in favor of this equal-division approach in the context of contract default rules as a matter of theory, it has no normative value in the real world. Contracting parties by definition know their circumstances, and therefore they cannot be required to negotiate terms from behind the veil of ignorance. Although contracting parties on average might be better off if they were to negotiate terms not knowing whether they were the buyer or the seller (and thus agreed to split cooperative surpluses), once parties do know their circumstances, their incentives are to maximize their individual surpluses. Without an agreement between all contracting parties to divide cooperative surpluses equally, backed by credible enforcement mechanisms (obviously an impossibility), rational parties will seek to claim as much of the cooperative surplus as they can during bargaining.

IV. CONCLUSION

We have leveled two primary criticisms at Swygert and Yanes's provocative proposal to integrate efficiency and equity in the development of private law rules. First, we have accused the authors of a sin of omission: failing to provide an account of how their theory would affect rules of entitlement allocation. Because the State is probably better able to create equity through its awards of entitlements than through regulating transactions after entitlements have been allocated, this is a significant omission. We have attempted to remedy this shortcoming by providing a theory of market-contrarian entitlement allocations. Second, we have suggested that a legal system concerned with equity as well as efficiency might do better to create legal rules that maximize efficiency

and then use the tax-and-transfer system to achieve equity, as the Second Fundamental Theorem of Welfare Economics suggests. We have contended that such a two-step approach to legal policy might be superior to a single-step approach because a two-step approach need not rely on the unrealistic assumption that all claimants to a given entitlement are equally wealthy *ex ante* and need not fear the wealth-reducing side effects of legal rules that take matters other than efficiency into account.

As a final note, we wish to point out one controversial assumption imbedded in Swygert and Yanes's article that goes unchallenged in our response. When Swygert and Yanes suggest that lawmakers build concerns for equity into legal policy by adopting the concept of a Rawlsian veil of ignorance, they implicitly adopt a specific view of what "equity" means: namely they adopt the utilitarian-based premise that *equal* distributions are *equitable* distributions, given the assumption of risk aversion. Although we have accepted this view of equity for purposes of our analysis, it surely will not receive universal acceptance. We have among us in the legal academy many different ideas about the content of such lofty ideals as "equity" and "fairness." Consequently, even if Swygert and Yanes's desire to combine equity with efficiency in legal policymaking were to gain widespread acceptance, we would still be far from achieving consensus on a more specific understanding of the goals of legal policy. We should surely continue to debate how legal policy can best serve both equity and efficiency, but we should not expect to reach any clear conclusions.