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John J. Donohue III

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SOME THOUGHTS ON LAW AND ECONOMICS AND THE GENERAL THEORY OF SECOND BEST

JOHN J. DONOHUE III*

The General Theory of Second Best is at once fascinating and paralyzing—fascinating because it so powerfully assaults much of modern economic theory; paralyzing in that it does not offer a clear replacement for what it purports to destroy. Richard Markovits, who has done so much to keep this important theory in the minds of law and economics scholars, gives an example that suggests the difficulty: suppose a tort doctrine is implemented which compels manufacturers to pay the cost imposed by their discharge of pollutants into any body of water.¹ At first blush, the policy change seems unambiguously good. Prior to the doctrinal change, manufacturers who dumped noxious chemicals and metals into bodies of water created “externalities”—social costs that they imposed with impunity. As a result, a manufacturer would maximize profits by discharging pollutants whenever there was even the slightest benefit in so doing. In other words, a market system, instead of providing incentives to promote the public good, will through the presence of large external costs encourage undeniably harmful activity. It would seem that eliminating this perverse incentive could only be beneficial, and, at least in the absence of the General Theory of Second Best, this logic would be unassailable. But once the disruptive General Theory of Second Best is introduced, all bets are off unless there happens to be no other distortion in the economy—a most unlikely event.

Say, for example, that the tort doctrine in question is designed to provide the appropriate price for water pollutants but still leaves manufacturers free to pollute the air without compensating for the social harm. In all likelihood, making the water polluters pay will lead to a shift to less water-polluting technologies and reduce demand for the goods produced by such pollution. Nonetheless, Markovits has noted ominously that it is just as likely that establishing ostensibly correct prices for water pollution “will decrease allocative efficiency on bal-

* Professor of Law, Stanford University; Research Associate, National Bureau of Economic Research.

1. See Richard S. Markovits, *Monopoly and the Allocative Inefficiency of First-Best-Allocatively-Efficient Tort Law in Our Worse-Than-Second-Best World: The Whys and Some Therefores*, 46 CASE W. RES. L. REV. 313, 320 n.7 (1996).

ance by giving the relevant actors an artificial incentive to make allocatively inefficient shifts from water-polluting to air-polluting production-techniques and locations."² Markovits' claim that it is "equally likely"³ that the doctrine in question will hurt as that it will help is true only in the sense that when you know nothing about which of two events will occur, you can assume they are equally likely. Nonetheless, his statement does dramatize the point that even tutored economic intuitions are suspect in the unsettling world of the second best. Moreover, Markovits' example also points out a danger of the General Theory of Second Best—it may be invoked opportunistically by water polluters to prevent *desirable* pollution laws, because it provides yet another hurdle to the correction of market imperfections.

But how can the act of discouraging something bad itself be harmful? An intervention that simultaneously discourages one bad outcome while encouraging an even worse outcome may well have an overall effect that is welfare-reducing. Grant that marijuana is bad and that avoiding its use is wise and we still cannot say that a policy of banning marijuana is good. If the marijuana ban encourages the use of alcohol which some suggest is a more socially harmful drug, the ban may increase total social costs.

I. INSIGHTS FOR REGULATORY POLICY

How should we respond to the General Theory of Second Best? Andrew Morriss looks at the problem of public utility regulation and is grateful to find another obstacle to the "correction" of market imperfections.⁴ Morriss argues that greater appreciation of the General Theory of Second Best would weaken our overconfidence "in our ability to forecast the impacts of regulation and precisely calibrate regulatory interventions."⁵ My sense, though, is that very few believe that economists can precisely calibrate the impact of regulatory interventions. Those in favor of interventions generally tend to overestimate the expected benefits and underestimate the expected costs, but I am not sure that the General Theory of Second Best is likely to be the best tool to correct these biases. Rather, a systematic study of the actual consequences of an array of interventions will probably be

2. *Id.*

3. *Id.*

4. See 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 (1998).

5. *Id.* at 137.

more persuasive to those in a position to influence policy than a somewhat arcane economic theory.⁶

Indeed, I would take Morriss's paper as a case in point. The positive consequences of deregulation in the phone company and airline industry—which second-best theory might have given little reason to expect—have probably done far more than any economic theory ever could to convince the public of the harms of needless regulation. As technological change enables previous natural monopolies to become competitive industries, the public will push for greater deregulation, and my guess is, despite the predictions of the General Theory of Second Best about the inability to make such guesses, superior products will be produced at less cost—which I take to be good. Of course, it is always possible that the greater production of the unfettered former public utilities will cause even greater social costs, if, for example, insufficient restrictions on the discharge of pollution causes that problem to grow sufficiently more severe. To use an analogy, we would rather that, say, criminal activity were supplied by a monopoly, with its accompanying depressing effect on output, than by a vibrant and competitive criminal enterprise.⁷

Morriss's understandable dismay with the shortcomings of governmental interventions cannot justify his broader suggestion that we might be better off with no intervention.⁸ The police, for example, are woefully inefficient, certainly little better than the post office or public schools in terms of the dubious efficiency with which they perform their respective tasks. Still, the evident shortcomings do not make out the case for the elimination of public police departments.

Morriss suggests we should all have greater humility when it comes to the arena of public policy.⁹ Yet one need not be a devotee of the General Theory of Second Best to heed the call for more humility. Indeed, one might take the fine paper by Don Fullerton and Gilbert

6. Yet even here, empirical evaluation is often difficult, the results are often inconclusive, and the consequent uncertainties tend to leave those with an axe ample opportunity to grind.

7. Indeed, one might make the point in general that monopolies that produce bad or harmful commodities may well be preferable to competitive production. Thus, the sugar price support system—a ludicrous pay-out to special interests—might be worthwhile in the second-best world if consumers tend to overindulge in sweets to their detriment. For the reasons discussed below, a sugar tax would be preferable to the sugar quota, but possibly more politically infeasible. In that event, the current price support regime might still dominate a competitive sugar market.

8. See Morriss, *supra* note 4, at 185-88 (advocating a contractual approach).

9. See *id.* at 137-38.

Metcalf¹⁰ as further evidence that nuanced and sophisticated analyses often overturn simple and intuitive economic arguments. This certainly counsels humility because even the conclusions of nuanced and sophisticated economic analyses may well be overturned by yet more nuanced and sophisticated approaches.¹¹

II. POLLUTION TAXES AND THE SECOND BEST

In comparing the Pigovian pollution taxes with command-and-control environmental regulations, Fullerton and Metcalf have, in essence, rehearsed the analysis of the difference between a tariff and an import quota.¹² Either policy instrument can limit the number of imports of, say, Japanese cars into America. The quota leads to higher prices for Japanese cars, with the monopoly profits pocketed by the Japanese automakers. The appropriate tariff leads to the same number of imported cars being sold at the same (after-tariff) price to the consumer, but the difference between the buying price and the cost of manufacture goes not to the Japanese but to the American treasury. It is not surprising, then, that the Japanese have been willing to submit to quotas "voluntarily," while they would never acquiesce to the imposition of tariffs.

In the pollution context, the choice between the pollution quota and the pollution tariff raises similar issues. The government wants the tariff, while the polluter wants the quota. Thus, Fullerton and Metcalf conclude: "the choice between pollution restrictions and pollution taxes is essentially a choice about who gets the scarcity rents. The pollution restriction leaves those rents in private hands, which might make the whole program politically palatable to business."¹³ The choice between tariffs and quotas in both the car and pollution

10. 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).

11. Examples of more refined analyses switching the conclusions of earlier economic models abound. Thus, an early model predicted that the British rule, in which losers in litigation pay all the litigation expenses, would increase the likelihood of settlement was followed by a subsequent model (by the same author) predicting that the British rule would decrease the likelihood of settlement, and then by a further analysis based on the work of Ronald Coase, indicating that the choice of the American rule or the British rule should have no impact on the rate of settlement. See John J. Donohue III, *Opting for the British Rule, or If Posner and Shavell Can't Remember the Coase Theorem, Who Will?* 104 HARV. L. REV. 1093, 1093-94 (1991). For a similar Odyssey involving the effect of joint and several liability on settlements, see the discussion in John J. Donohue III, *The Effect of Joint and Several Liability on the Settlement Rate—Mathematical Symmetries and Metaissues About Rational Litigant Behavior: Comment on Kornhauser and Revesz*, 23 J. LEGAL STUD. 543 (1994).

12. See Fullerton & Metcalf, *supra* note 10, at 225-32.

13. *Id.* at 229.

cases does not affect the consumer's position;¹⁴ the only difference is whether manufacturer or government will gain the scarcity rent.

While clearly the pollution tax is superior to the pollution quota, Fullerton and Metcalf note that the tax does lower the real wage, which may exacerbate the distortion generated by existing income taxes.¹⁵ Even though the pollution tax furnishes the public good of a better environment, it simultaneously raises the cost of the manufactured good, which is the good purchased from the income of labor. Starting from the baseline of unrestricted pollution, the pollution tax makes the act of working less valuable. Presumably, citizens benefit from the cleaner air or water that the pollution tax buys, but this benefit goes to everyone, whether they work or not. As a result, compensation for hours worked falls, thereby causing a distortionary move towards greater leisure. Whether this distortionary burden is greater with the labor tax or the pollution tax is a vexing question, which the General Theory of Second Best tells us cannot be resolved absent empirical evidence.

There is a possible final irony in Fullerton and Metcalf's demonstration that many scholars have been unduly optimistic in asserting that pollution taxes will yield the double-dividend of a better environment and more tax revenues with less deadweight loss. In so doing, Fullerton and Metcalf have certainly diminished the prospect, advocated by some, that excess pollution taxes will be imposed to reduce the deadweight loss from distortionate labor taxes. Their paper also shows, however, that, the pollution tax is preferable to the pollution quota.¹⁶ Because Fullerton and Metcalf demonstrate why business strongly prefers the quota to the tax,¹⁷ we may have our own ironic version of the second best in operation here.

Three states of the world are plausible: (1) the overtaxation state that Fullerton and Metcalf attack; (2) the precise Pigovian tax rate that they presumably endorse; and (3) the command-and-control regulation (the undertaxation state) that business so strongly prefers. Because the pressures of special interests have clearly biased policy towards state (3), arguments in favor of position (1) might have corrected the political imbalance, thereby making position (2) more likely. Now that Fullerton and Metcalf have strongly denounced position (1), the counterbalance to the special interest bias towards state

14. *See id.* at 228.

15. *See id.* at 228-29.

16. *See id.* at 229-30.

17. *See id.*

(3) is removed, making (3)—the admittedly worst of the three outcomes—more likely than (2). This is clearly a frustrating aspect of the General Theory of Second Best because if the analysis of imperfections extends to political failures, then making truthful claims about the undesirability of certain policies may cause more harm than good. It is not hard to see why most academics shy away from this broad conception of the theory.

III. THE ROLE OF LAW AND ECONOMICS

Thomas Ulen has given a wonderfully clear overview of the mission of law and economics, with its animating theoretical vision based on the need for correcting various market imperfections.¹⁸ His paper counsels that the type of sophisticated analyses promoted by Fullerton and Metcalf, as well as by Markovits, are commendable exercises for scholars and may profitably influence the choices of legislatures. When it comes to the creation of legal doctrine in private litigation, however, Ulen makes the entirely plausible argument that institutionally the judge is not in a suitable position to consider much more than the local effects of legal rules on the parties.¹⁹ Therefore, Ulen views second-best considerations to be beyond the legitimate province of the common law judge.²⁰ The modal tendencies of Ulen's advice certainly ring true for me: ["P]rivate law is more appropriate than legislation for addressing inefficiencies when second-best effects are trivial; legislation is more appropriate than private law for addressing inefficiencies when second-best effects may be large and widely distributed."²¹ Of course, the messiness of the legislative process often means that important policy decisions will be left in the hands of judges owing to the ambiguity of the legislative command. Indeed, it is not implausible that such ambiguities will be greatest when many widely dispersed parties are vying to have their second-best interests influence the outcome of the legislative process. In other words, the demands on the judiciary to render policy judgments may be greatest in exactly the situation where their institutional competence is most limited.

18. Thomas S. Ulen, *Courts, Legislatures, and the General Theory of Second Best in Law and Economics*, 73 CHI.-KENT L. REV. 189 (1998).

19. *See id.* at 217.

20. *See id.*

21. *Id.* at 219.

The abstruse nature of Markovits' paper²² implicitly makes the argument for Ulen's conclusion that judges should not try to engage in second-best analysis. The complexity of second-best analysis would quickly overwhelm the capacity of all but the most economically sophisticated judges, and the parties would be unlikely to offer significant assistance in tracing out all of the distant general equilibrium effects of any particular doctrinal change. Indeed, Markovits would no doubt embrace Ulen's recommendations that the place for a full consideration of second-best factors is in the legislature—hopefully with the benefit of the rich array of empirical data that is needed to fully implement the analysis. But while Ulen is satisfied to let judges seek efficiency in the mode of the traditional law and economics scholar, Markovits wants to use the General Theory of Second Best as the battering ram to destroy this traditional approach. Once judges realize the futility or impossibility of trying to trace out the efficiency implications of their rulings, they can “make their decisions appropriately reflect rights-considerations, distributional values, and process-related (participation) values.”²³

Of course, the power of the criticisms that Markovits seems to level against law and economics methodology depends upon what that methodology is trying to accomplish. Economic modelling necessarily requires skill in making simplifying assumptions, because one must transform complex mathematical problems into more tractable forms capable of yielding findings that are both illuminating and easily packaged for publication or classroom presentation. If the goal of law and economics is to organize our thinking, then it has largely been successful. If the goal is to give accurate predictions and policy assessments, then Markovits' criticisms are far more telling. But an example from the realm of the physical sciences reveals that even an unassailably important law of nature can be a very bad predictor. Thus, we know that in a vacuum, a feather and a cannonball will fall at the same speed if dropped from the same height. But if one woodenly applied this law of gravity in trying to predict whether the feather or the cannonball would hit the ground first if dropped from the Empire State Building, the results would be ludicrous. Good and useful theory depends on the use to which it is to be put. Simplifying assumptions may yield valuable insights in some circumstances, even though their viola-

22. 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 (1998).

23. *Id.* at 134.

tion undermines the predictive value of the resulting conclusions. One would not want a scientist to throw out the laws of gravity because they fail to predict the consequences of wind acting on an ethereal body.

While the simplifications of the physicist at times seem extreme, they are nothing compared to what is needed to render the complex social world tractable. For example, I have previously discussed "John Prather Brown's decision to divide the world into two discrete classes—injurers and victims—in setting forth the initial formal economic model of tort law in 1973"; this choice facilitated the analysis of the tort doctrines of strict liability and negligence because strict liability makes little sense unless one party can be identified as "the injurer" and the other as "the victim."²⁴ Absent this dichotomy it would thus be difficult to build a model of strict liability for accidents between two automobiles, because neither party would obviously be the victim or the injurer.²⁵

As is now well known, given Brown's model and his other crucial simplification that the only factor that affected accident risk was the level of care taken by the respective parties, he concluded that both a negligence standard and a strict liability rule with a contributory negligence defense would induce injurers and victims to take the optimal level of care.²⁶

But in 1980, Shavell observed that the number of accidents would be affected not only by how careful injurers and victims were—their level of care—but also by how much they engaged in the particular activities that gave rise to accidents—their activity level.²⁷ For example, increases in the amount of driving, even by a careful driver, will certainly increase the risk of an accident. By altering Brown's model, Shavell demonstrated that no liability standard could simultaneously give both injurers and victims the proper incentive to choose the optimal levels of care and activity.²⁸

The reasoning behind Shavell's point is that a negligence standard puts pressure on injurers to act with due care to avoid the poten-

24. John J. Donohue III, *The Law and Economics of Tort Law: The Profound Revolution*, 102 HARV. L. REV. 1047, 1057 (1989).

25. See WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 115 (1987).

26. This conclusion was also reached by Peter Diamond. See Peter A. Diamond, *Accident Law and Resource Allocation*, 5 BELL J. ECON. 366 (1974); Peter A. Diamond, *Single Activity Accidents*, 3 J. LEGAL STUD. 107 (1974).

27. See Steven Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1, 2 (1980).

28. See STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 29-30 (1987).

tial liability payments that exceed the cost of taking care. But a negligence standard will not give injurers a financial incentive to limit their activity level because they avoid all liability by simply taking due care. Conversely, the negligence rule gives victims an incentive to control both their level of care and their activity level, because they cannot look to careful injurers for any compensation. Strict liability with a contributory negligence defense creates the exactly reciprocal pattern: injurers would face the appropriate incentives with respect to care and the activity level, but victims would have no incentive to control their activity level.²⁹

But even though Shavell's economic model has generated a very interesting finding concerning the activity levels of the parties, the neat conclusion that courts find the efficient levels of care but tend to ignore the amount of activity may well be erroneous. The reason is that, in general, courts cannot determine the optimal level of care without simultaneously knowing the optimal activity level. Hence, in circumstances in which the proper due care standard varies as activity level changes, the inability of courts to evaluate the costs and benefits of different activity levels means that their liability rules will generate neither optimal care nor optimal activity levels.

Once again, a strong conclusion was reached about an important aspect of tort law (the activity level/duty of care dichotomy) only because Shavell imposed certain restrictive conditions—namely, that an increase in the activity level will affect neither the marginal cost nor the marginal benefit of taking care. Yet, these conditions are often violated:

A trucker will presumably find it more difficult to stay alert—that is, more costly to take care—if he has to drive all night as opposed to only a few hours. Furthermore, if the trucker keeps driving through rush-hour traffic, the benefits from heightened care will escalate because of the higher accident risk posed by the greater congestion.³⁰

Once all the bells and whistles have been added on to any economic model, the simple and elegant predictions that sometimes capture the imagination of certain academics, judges, and policymakers are often reversed or heavily qualified. That should certainly give one pause before relying too heavily on theoretical economic models as a tool for crafting policy. Because the General Theory of Second Best is

29. Indeed, victims would have no incentive to control either their activity level or their level of care without the contributory negligence defense, which gives them an incentive to be careful. *See id.* at 27-29.

30. Donohue, *supra* note 24, at 1062.

just one more illustration of this general point, Markovits' strong admonition of caveat emptor in the world of law and economics is probably useful advice. However, harkening back to the earlier discussion of Fullerton and Metcalf's paper, it is possible that the weakening of the reliance on law and economics might lead to greater reliance on even less beneficial modes of analysis. Wise and well-informed policy-makers are probably our only hope of achieving good results, and if law and economics can at least illuminate some of the relevant considerations, then we should value that useful, albeit necessarily limited, contribution.