
Behavioral Economics and the Law

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Behavioral Economics and the Law

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Abstract

This monograph describes and assesses the current state of behavioral law and economics. Law and economics had a critical (though under-recognized) early point of contact with behavioral economics through the foundational debate in both fields over the Coase theorem and the endowment effect. In law and economics today, both the endowment effect and other features of behavioral economics feature prominently and have been applied to many important legal questions.

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1

Introduction: Behavioral Economics on the American Legal Stage

Over the past quarter century, behavioral economics has gone from a small subfield of economics to a powerful force within American society. Nobel Laureate Daniel McFadden, not himself a behavioral economist, asserted in 2001 that behavioral economics was “where gravity is pulling economic science” (Lowenstein, 2001). Rather than focusing on how a theoretical and often highly unrealistic “homo economicus” might make decisions, economics has increasingly turned its sights to analysis based on how real people actually behave. Such behavioral economics analysis seeks to enhance the predictive power of economics by improving its underlying model of human behavior.

In the years since McFadden identified the “gravitational” pull of behavioral economics, Daniel Kahneman has been awarded the Nobel Prize for his foundational work in behavioral economics, while the United States has elected its first “behavioral economics President” (see, for example, Grunwald, 2009; King, 2009). In a broad range of contexts, the Obama Administration has turned to behavioral economics, whether the legal policy question is how jobless benefits and job training should be structured in today’s economy (Kling, 2009) or whether environmental and safety regulations satisfy cost-benefit analysis (Wallace-Wells, 2010).

2 *Introduction: Behavioral Economics on the American Legal Stage*

This monograph begins with the early evolution of behavioral economics both outside and within legal policy analysis and then describes the central role of behavioral economics in such analysis today. The “behavioral law and economics” of today is rooted in more traditional law and economics, so it is useful to start with an understanding of the field’s jumping-off point.

Three distinctive features help to demarcate work that is typically regarded as within the field of law and economics.¹ First, work within law and economics focuses, among the huge range of economics topics that relate to law in some way, on areas of law that were not much studied by economists prior to the advent of law and economics as a field; these areas include tort law, contract law, property law, and rules governing the litigation process. Second, law and economics often (controversially) employs the normative criterion of “wealth maximization” (Posner, 1979) rather than that of social welfare maximization — not, for the most part, on the view that society should pursue the maximization of wealth rather than social welfare, but instead because law and economics generally favors addressing distributional issues that bear on social welfare solely through the tax system (Shavell, 1981). Third, much work within law and economics reflects a sustained interest in explaining and predicting the content, rather than just the effects, of legal rules. While a large body of work in economics studies the effects of law (see Jolls, 2007a for examples), outside of work associated with law and economics only political economy has generally given central emphasis to analyzing the content of law, and then only from a particular perspective.²

Behavioral law and economics has sought to bring the insights of behavioral economics to bear on many topics within the field of law and economics. This monograph describes a number of the central attributes and applications of behavioral law and economics to date. It does not embrace every area in which behavioral economics has become

¹ The remainder of this paragraph is reprinted with minor changes from Jolls (2007a), which also provides examples of the broad scope of work in economics that relates to law in some way.

² The three features of law and economics identified in the text are not meant to demarcate the intrinsic essence of the field; instead the claim is that these features characterize much of the existing work generally regarded as within law and economics.

influential in legal policy in America and beyond,³ but it does seek to give a representative sample of the burgeoning modern field of behavioral law and economics.

Section 2 begins with the early development and refinement of one of the pivotal insights of behavioral economics — that people frequently exhibit an endowment effect — both outside and within the field of behavioral law and economics. The endowment effect refers to people’s tendency to assert a higher value for an object or right if they possess it initially than if they do not. While the empirical evidence of the endowment effect is compelling, it is clear that the effect is context-specific. Within law, it is thus critical to attend to the legal context in assessing the likelihood and significance of the endowment effect.

Section 3 offers a general overview of the features of human decision making that have informed modern behavioral law and economics. As in Thaler (1996), the discussion is organized by reference to three “bounds” on human behavior: Bounded rationality refers to both judgment error and departures from expected utility theory; bounded willpower refers to people’s failure to adhere to their previously laid plans; and bounded self-interest refers to departures from material self-interest maximization.

Section 4 provides a general typology of legal responses to bounded rationality, bounded willpower, and bounded self-interest. In many instances of bounded rationality, the behavior in question is uncontroversially viewed as an “error,” and in such cases law often should — and does — seek either to *debias* the mistaken actor or to *insulate* outcomes from the effects of the actor’s mistake. In some behavioral law and economics applications, however, actors’ behavior cannot be straightforwardly categorized as erroneous or otherwise normatively undesirable; in such cases, behavioral law and economics often focuses on positive or descriptive, rather than normative, analysis.

Sections 5 through 7 move from the general to the concrete, offering a range of illustrative applications of behavioral law and economics in the domains of bounded rationality, bounded willpower, and bounded self-interest, respectively. A particular emphasis in recent applied work

³For an example from abroad, see Chakraborty (2008).

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has been legal debiasing approaches (see especially Section 5.4). Greatly predating the broad range of modern topics in behavioral law and economics, however, was the early focus of both behavioral economics and behavioral law and economics on the endowment effect, the topic of Section 2.

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