Fire with Fire: Heterodox Law & Economics

Karl T. Muth

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Karl T. Muth*

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* Karl T. Muth 2009 - 10. I am honored to have studied the economic analysis of major policy issues with Gary S. Becker, Kevin M. Murphy, and Ted Snyder at the University of Chicago. This article, while critical of aspects of the law and economics movement, is written with immense respect for mentors and colleagues at Chicago. Thanks to Steve Durchslag, John Goldstein, David Grewal, Kathryn McElligott, Ian Simmons, and Brooke Skinner for friendship and support. Elizabeth M. Schutte contributed very helpful comments and criticism related to earlier drafts. Very special thanks to the London School of Economics and Political Science, where I enjoyed my time as a visiting graduate student, and where much of this article was written. This article is dedicated to a close friend who once very wisely said, "There is more than one right way to do most things."
"For the rational study of the law the black-letter man may be the
man of the present, but the man of the future is the man of statistics
and the master of economics."

O. W. Holmes, The Path of the Law (1897)\(^\text{1}\)

"Economic analysis is not a single great searchlight that will pene-
trate and illuminate every nook and cranny of the law[.]

Charles J. Goetz, Law and Economics (1984)\(^\text{2}\)

I. INTRODUCTION

Once upon a time, law and economics\(^\text{3}\) were separate disciplines. The former evolved from classical philosophy, providing a method for normative reinforcement developed over the generations. The latter blossomed from applied mathematics and a need to understand the mechanisms of early, rapidly-developing commodities markets. Though hard to imagine in retrospect, the acorn from which law and economics grew fell squarely on the law side of the fence, with law providing the initial network of problems and solutions that many twentieth century economists sought to improve.\(^\text{4}\)

The application of economic principles by scholars and judges progressed quickly from 1880 through 1960, with mathematical formulas devised to examine the existence of a duty in negligence cases,\(^\text{5}\) the magnitude of damages in contract disputes,\(^\text{6}\) and the concepts of copyrights\(^\text{7}\) and option contracts.\(^\text{8}\) These applications were of two distinct

\(^{1}\) O.W. Holmes, The Path of the Law, 10 Harv. L. Rev. 457, 469 (1897).
\(^{3}\) "A unified theoretical framework capable of accounting for a large variety of different kinds of phenomena has been established as a regulative ideal of economic inquiry. This has further ramifications for the expansion of economics to the domains of neighboring disciplines, as in the much disputed 'economics imperialism.'" Uskali Maki, Realistic Realism About Unrealistic Models, in THE OXFORD HANDBOOK OF PHILOSOPHY OF ECONOMICS (Harold Kincaid & Don Ross eds., 2009).
\(^{5}\) See, e.g., United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947).
\(^{7}\) See Note, Parody and Copyright Infringement, 56 Colum. L. Rev. 585 (1956). Debate continues as to the compatibility of common law concepts and law and economics frameworks – for instance, whether the "bundle of rights" conception of property is complete and accurate in an economic sense. See Richard A. Epstein, The Disintegration of Intellectual Property 6, 7 (Univ. of Chi. Law & Econ., Working Paper No. 423, August 2008) (arguing that "bundle of rights" approach is correct and complete approach to describing property rights).
categories: evolutions of balancing tests and evolutions of economic calculations. In the first group, a question was normally resolved with a balancing test, such as whether the alleged tortfeasor had a duty, which was reduced to a formula where, if \( B < P^*L \), a duty existed. In the latter group, one finds a variety of efforts to adapt economic calculations invented for finance, valuation, or accounting purposes to solving questions as to civil damages. In both, the goal is to replace speculation with certainty, to replace semantics with formulas, and to find accepted, concrete methodologies for calculating the result of a controversy. As the race to replace art with science progressed, however, several important questions were abandoned along the way.

Law and economics has become a beautiful mirage in the desert of legal uncertainty, alleged to prescribe, rather than simply describe, the relationships between legal principles and economic theories. By replacing the legislator with the calculator, making legal rules with slide rules, new economically "efficient" laws may better represent the data, but poorly represent the people. Never before have so many learned scholars at so many respected institutions broadly advocate replacing the reasonable person with the invisible hand. Economics and law is a young mixture, the result dependent upon the method used to blend the two. The role of neoliberal "freshwater" economists in structuring this merger has set its recipe and altered its flavor. But there are issues this primarily Chicago School thrust of the law and economics movement either cannot address or has failed to foresee. If the present is merely fluctuation and inefficiency as the world bounces toward a settled equilibrium, perhaps a broader approach is warranted to attempt to understand the imperfect present, rather than a future state of equilibratory bliss. The state of the art in law and

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9. In Learned Hand's "calculus of negligence" as explained in Carroll Towing, "B" represents the burden of taking precautions to prevent the plaintiff's loss. Carroll Towing Co., 159 F.2d at 173.169.
10. The term "P * L" is an expression of the probability of loss multiplied by the gravity of that loss. Id.
12. The evolution of legal terms of art defined by economic principles is a fascinating contemporary trend and a topic too rich to be explored in detail here. For example, "joint profit" in modern property law, which is the productive uses added together, less the negative externalities each inflicts on the other, less integral transaction costs. Robert Cooter & Thomas Ulen, Law and Economics 100 (3d ed. 2000).
II. Law & Economics: The First Crusades

The interaction of law and economic concepts in the legal tradition of the late nineteenth century dated back to at least the German reformation; tragedies of the commons were to be avoided; where a party could be improved without hurting any other parties, this was desirable and unanimously agreeable logic was superior to unilateral, despotic decrees. These seemingly simple and universal concepts led, however, to a road never before traveled in human history (or Western jurisprudence). While these ideas evolved in the lakes of freshwater\textsuperscript{14} economic thought, they are now pervasive throughout academic institutions of all persuasions. Throughout this Article, "traditional" or "mainstream" law and economics refers to analysis from a freshwater, neoliberal, libertarian position.

A. Coase and Calabresi

The central texts in the early evolution of what we describe today as law and economics are, almost without question, Ronald Coase's \textit{The Problem of Social Cost}\textsuperscript{15} and Guido Calabresi's \textit{Property Rules, Liability Rules, and Inalienability}.\textsuperscript{16} As Lewis\textsuperscript{17} had done in the previous century,\textsuperscript{18} Coase\textsuperscript{19} and Calabresi focused on the creation, appraisal,
and destruction of economically valuable rights in property.\textsuperscript{20} These texts were chiefly analytical, academic, and apolitical.\textsuperscript{21}

\textbf{B. Becker and Posner}

The University of Chicago is the epicenter of the first modern (twentieth century) movement in law and economics. At Chicago, Henry Simons\textsuperscript{22} and Aaron Director\textsuperscript{23} led a charge to implant economic principles deep into the heart of legal thought. Under Director's leadership, Gary Becker\textsuperscript{24} and Richard Posner\textsuperscript{25} drew upon and interpreted the work of Coase and Calabresi's, as well as others.\textsuperscript{26} At the same time the torch was being passed from Calabresi to Posner, H. Scott Gordon was publishing work on the dilemma of finite resources,\textsuperscript{27} which flourished into the core arguments for environmental stewardship law in the twenty-first century.\textsuperscript{28}

\textbf{C. Pareto Efficiency, Kaldor-Hicks Efficiency, and Associated Building Blocks and Improvement Paradigms}

Most calculations of efficiency begin from one of two starting points: either transaction cost as a discount from perfect efficiency or opportunity cost calculated by examining the value of the subject option relative to particular outside options. Assumptions about transaction cost\textsuperscript{29} and opportunity cost give rise to models in areas as diverse as stock options and labor unions. Because the universe of

\textsuperscript{20} This remains a central focus of study in law and economics. See, e.g., Thomas W. Merrill & Henry E. Smith, \textit{Optimal Standardization in the Law of Property: The Numerus Clausus Principle}, 110 YALE L.J. 1 (2000).

\textsuperscript{21} Though his work is considered to generally bolster conservative political positions and conservative fiscal policy, Calabresi was nominated to the United States Court of Appeals for the Second Circuit by President Bill Clinton, a Democrat.

\textsuperscript{22} See \textsc{Henry C. Simons, Economic Policy for a Free Society} (1948).


\textsuperscript{26} Particularly Robert Cooter and Henry Manne.


outside options is limited in conventional decision-making models, and not all implications of each choice may be known at the time the decision is made, the real costs may be difficult to weigh ex ante. These trade-offs are often (erroneously) valued as a function of the best alternative's marginal efficiency or productivity when compared to the “next-best” alternative. Put another way, trade-offs are valued in terms of whether marginal improvements can be made by making a different available choice at the same point in time, even when that choice (if made at the same time) may be impracticable or involve agency costs.

Law and economics created a set of tools for evaluating trade-offs, much as Learned Hand had in Carroll Towing decades earlier. One of the questions that quickly emerged was whether Pareto improvements could be made through legislation, legal rules, or procedural safeguards. The Pareto improvement paradigm can be seen in a wide variety of favorite topics in law and economics, from efficient breach to labor relations.

Very quickly, the question of what improvements are possible in a “harmless” set of exchanges came under fire. Courts in the United States are courts of law and equity, and the most economically elegant legal rule may not produce “fair” or philosophically appealing results. Though it may be tempting to separate the forging of law and the finesse of policy for the sake of academic discourse, this is a dishonest practice if the debate is to yield any valuable fruit.

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30. When choosing between A and B, often C or the option to do nothing at all are not considered.

31. This is a primary criticism of Pareto efficiency as a law and policymaking tool, as discussed infra.

32. This is similar to the “admissible decision rule” in decision theory or the valuing of adjacent nodes in Bayesian analysis.

33. United States v. Carroll Towing Co., 159 F.2d 169 (2d Cir. 1947).

34. A Pareto improvement, in economics, is a move toward Pareto efficiency. If one has resources to allocate among a set of subjects and resources can be re-allocated in a way that improves the situation of one subject without harming the situation of any other subject, this is a Pareto improvement.


37. For Calabresi's most comprehensive salvo in this ongoing academic debate, see Guido Calabresi, The Pointlessness of Pareto: Carrying Coase Further, 100 Yale L.J. 1211, 1221-27 (1991) (discussing Kaldor-Hicks and dismissing existence of information parity required to analyze Pareto improvements ex ante).

38. “I crave the law” (as opposed to equity). William Shakespeare, The Merchant of Venice act 4, sc. 1, line 142 (Shylock).
Assume the world contains eleven economic agents and that all agreed-upon contracts, debts, and barters between them have been satisfied in full. The world has reached an equilibrium where no exchange can occur where the marginal benefit enjoyed from the exchange exceeds the marginal cost required; there are no discrete allocative inefficiencies that can be identified. At time $t_0$, one agent has 99% of the world's resources, the others 0.1% each. It is not possible to make any of the ten inferior agents "better" in $t_1$ (in Pareto terms) without taking from the wealthiest agent. Yet, most would agree the distribution of resources among the eleven at $t_0$ may not be optimal. From a policy standpoint, "Pareto optimal" is not synonymous with "unimprovable."

Hence, in many policy-centered law and economics circles, the concept of Kaldor-Hicks efficiency has replaced Pareto efficiency as the metric for acceptable incremental improvements. Under Kaldor-Hicks efficiency, an outcome is considered incrementally more efficient where those who enjoy gains can compensate any parties who are put in a less desirable position. One of the core weaknesses of Kaldor-Hicks efficiency as a law and economics tool is that it manages distributions nicely, but in complete ignorance of the breadth of the curve. So, for instance, in a welfare model Kaldor-Hicks improvements may offer theoretical advantages that do not raise the standard of living of any of the people involved. Kaldor-Hicks efficiency is also non-symmetric and non-exclusive. Most problematic of all, it is unclear what "settlement price" the disadvantaged individuals would demand in compensation from the advantaged individuals, or how this price would be reached.

39. "It is twice blest; It blesseth him that gives and him that takes." Id. at lines 184-85 (Portia).
40. The key word here is "can" and not "will." Kaldor-Hicks improvements consider whether the improved party could compensate any parties disadvantaged, not whether such compensation would actually flow from one party to another.
41. As may be obvious to many readers at this point, just as squares are rectangles but rectangles are not always squares, Pareto improvements are Kaldor-Hicks improvements, but not vice versa.
44. "Exclusive" here is used in the game theory sense rather than the mathematical sense. In other words, "A dominates B" does not mean that B cannot dominate A.
45. Some claim this price must be built into wholesale regulation, as in a Pigovian tax or Pigovian subsidy, while others claim this price could be privately negotiated (as in the case of class action lawsuits) or set in an auction market (as in the case of carbon dioxide emissions...
To understand the weaknesses in the way many economists visualize improvements, one must first understand where and how the concept of "improvement net of transaction cost" was born. In microeconomic analysis, improvements are scrutinized after deducting their transaction costs; in other words, if the cost of making a change outweighs the benefits of that change, the change is not net-positive or an "improvement." While this sounds logical, in practice it is difficult to measure (and even harder to predict) actual costs associated with any action. The idea of transaction cost, in mainstream American economics, has been seen as a discount from perfect efficiency: a wrinkle in otherwise perfect markets. In truth, transaction costs are woven into the very fabric of markets and are rarely bilateral or simple in nature. To illustrate this, consider a typical example.

State is a government, while party corporation is a corporate entity involved in manufacturing asbestos. State has instituted a pollution trading system in which State determines the quantity of harmful material emitted from party corporation's factory and party corporation buys coupons from State (or in the market) equivalent to its level of harmful material emissions. While this appears to be a simple bilateral transaction, the underlying exchange does nothing to account for harm to party corporation's customers, workers, and others, nor the cost to society in health care costs, increased litigation, and remediation.

Transaction costs are, then, only a subset of the entirety of costs. Broadly considered costs are often overwhelmingly large, exceedingly hard to predict ex ante, and unlikely to be something third parties are eager to finance. Returning to the example, the overall costs of party corporation throughout the twentieth century include costs stemming from environmental damage, health costs, and litigation. The marginal benefit to the firm from each ounce of asbestos sold would have to be almost unimaginably immense to offset these factors. However, the information disparity (ignorance as to the health issues associated with asbestos) would make it almost impossible for even the keenest economist to foresee the firm's trajectory (or to craft appropriate legislation).


46. Many have criticized law and economics scholars for ignoring or unrealistically discounting the importance of transaction costs. See, e.g., Robert C. Ellickson, A Critique of Economic and Sociological Theories of Social Control, 16 J. LEGAL STUD. 67 (1987).

47. Robert C. Post, Constitutional Scholarship in the United States, 7 Int'l J. Const. L. 416, 422 (2009) ("[L]aw and economics is driven by its own internally generated telos of efficiency, it is relatively unresponsive to the evolution of political commitments").
The question at the macro-policy level, then, becomes why one action is better than any other, or better than no action at all. Further, one must ask how much utility individuals will enjoy both individually and collectively. Since cardinal utility theory has fallen into disuse, new theories evolved in order to allow for incremental positive adjustments (Pareto improvements, for instance). But these new and improved methodologies for ameliorating society at large pay no attention to addressing any individual's utility and satisfaction.

While cardinal utility theory may have been flawed in its specifics, modern non-parametric or ordinal rankings of utility are simply not fine-grained enough for the resulting indifference curves to accurately portray individuals' choices. The modern law and economics movement attempts to address entire systems far from what were seen as market behaviors throughout most of the twentieth century, and far from the level at which individual actors perceive adjustments.

H. Scott Gordon noted this problem in the context of environmental regulation in the first issue of the Journal of Law and Economics. While macro-level comprehensive models are seductive simplifications, the individual has the opposite perception problem. It is difficult for the fisherman to see the impact of the single marginal fish

48. Cardinal utility theory dictates that the utility an individual enjoys from a good or service can be quantified and compared (in ratios and formulas) with the utility of other possible distributions goods, services, and resources. Cardinal utility theory, in the strictest sense, fell out of favor in the latter part of the twentieth century.


50. "No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable." Adam Smith, The Wealth of Nations (1776).

51. An indifference curve, in economics, is the convex curve along which the subject will consume any combination of X and Y, with diminishing marginal utility for either at the tails of the curve. Tracing the indifference curve, one finds the marginal rate of substitution, or the rate at which an actor would be willing to have less Y in exchange for more X, and vice versa. Because the universe of options available to the individual is seldom bound or describable in a two-dimensional function, indifference curves are often seen as useful, but inherently flawed, descriptions of the choices actors in the marketplace might make. See David Colander, Microeconomics 325-39 (8th ed. 2009).


until there are no more fish to be caught. Because gradual change is difficult to observe and because the degree to which trailing indicators lag is equally difficult to estimate, even relatively specialized preference models may not fit individual perceptions or activities.

III. THE ILLUSION OF UNANIMITY

Many judges seem to consider economists as a bloc, a herd of interchangeable voices with methodologies so settled and identical that any inconsistent outcome is surely erroneous. As a result, the conclusion of one or a few economists comes to be routinely attributed to "economists" in general. Yet, in courtrooms and classrooms across the country, law and economics was, and to some extent still is, seen as a monolithic thrust from one direction, without dissent.

According to various scholars and courts, economists believe, for instance, that generally accepted index methods for estimating inflation both overstate and understate changes in the cost of living.

56. See The Sun Also Rises, ECONOMIST, Aug. 8, 2009, at 25.
58. See, e.g., Khan v. State Oil Co., 93 F.3d 1358, 1361 (7th Cir. 1996) (Posner, C.J.) (aff'd in part, rev'd in part) (discussing what "most economists" believe with no trailing citation); Scariano v. Justices of Sup. Ct. of State of Ind., 47 F.3d 173, 174 (7th Cir. 1995) (Posner, C.J., dissenting) (asserting that "most economists" believe minimum competence of lawyers is best protected through "free competition among lawyers," with no citation or reference to authority); Nielsen v. United States, 976 F.2d 951, 953 (5th Cir. 1992) (describing what "most" economists believed as to Brazilian hyperinflation crisis with no trailing citation). But see F.T.C. v. Owens-Illinois, Inc., 681 F. Supp. 27, 47 n.58 (D.D.C. 1988) (Green, J.) (explaining view of "most economists" as to Herfindahl-Hirschman Index with adequate support and explanation). Only when claims attributed to the entirety of economists are particularly outrageous do the courts seem to take notice. See, e.g., United States v. McHenry, 951 F.2d 364, 1991 WL 278830, at*2 (C.A.9 (Ariz.)) (court questioned claims by defendant, purveyor of silver dollars, that "economists believe investing in silver dollars is one of the most secure investments") (quoting court's restatement of defendant's claims).
59. This trend arguably originated at the University of Chicago, with Posner's Economic Analysis of Law, first published in 1972. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (1972). The book portrays the rules of society at common law as a search for economic efficiency among actors with disparate motives and interests. The book's introduction at law schools, including Chicago, was the first exposure to any interdisciplinary thought about law and economics for many law students in the 1970s and early 1980s.
61. See the methodology proposed by Dr. Bassett in Sauers v. Alaska Barge, 600 F.2d 238, 246 n.15 (9th Cir. 1979). See also the court's unusual methodology for computing wages in terms of
Rather than an entire mob of economists being confused whether use of the CPI factors overstates or understates change in the cost of living, there is disagreement among economists. Yet, an idea that "economists" think about complex problems in a uniform way and come to unanimous conclusions persists. The illusion of a unanimous set of beliefs from economists, beliefs quite rarely in conflict with the beliefs of the judge authoring the opinion in question, is a troubling facet of law and economics where the former speaks on behalf of the latter when convenient.

IV. The Reagan Era: Of Welfare Queens and Other Myths

Reagan repeatedly told tales of abuses at the edge of the system, from abuse of the welfare system\textsuperscript{62} to poor Latin American governance.\textsuperscript{63} These are, no doubt, powerful images that tend to reinforce certain political views\textsuperscript{64} and stereotypes.\textsuperscript{65} It was Reagan’s opinion that market forces could be put to work to rein in subsidies and substantially narrow the effect of programs like welfare; this was in essence a Chicago approach.\textsuperscript{66}


67. \textit{Nomination of Robert H. Bork to be Associate Justice of the Supreme Court of the United States: Hearing Before the S. Comm. on the Judiciary}, 100th Cong. 2411-90 (1987) (testimony of witness panel 12, including testimony of the Author).
The Role of the Courts in Applying Economics.\textsuperscript{68} Conservative economists quickly realized Bork's generally non-interventionist views on antitrust could offer an opportunity for a conservative shift on other law and economics issues.\textsuperscript{69} This was likely a sound bet, as Bork and Easterbrook\textsuperscript{70} had taken up the broad efficiency position\textsuperscript{71} of the Chicago School\textsuperscript{72} in a series of articles.\textsuperscript{73} Though some doubt whether the Chicago School positions of this era truly changed the law,\textsuperscript{74} the positions certainly foreshadowed the direction of law and economics, which would generally be characterized by conservative-leaning, non-interventionist,\textsuperscript{75} and laissez-faire, pro-free-trade positions.\textsuperscript{76}

A. Welfare as a Beachhead in Labor Economics

Welfare and the minimum wage have been key issues for politicians looking to the law and economics movement for support. While the wage debate has evolved substantially since the 1970s and early 1980s,\textsuperscript{77} the welfare debate has remained an active battlefield domi-
nated by now decades-old arguments. Welfare became a race issue, an urban-versus-suburban issue, and a class issue during the 1980s. Appeals to economic experts allowed Republicans a way to propose policies without confronting racial, urban-nonurban, and class conflicts.

There are efficiency costs inherent in raising income through traditional welfare programs, through taxing and transferring wealth between socioeconomic classes, or through litigation. However, the goal of the law cannot solely be “efficiency” without any social aim. While waste must be combated and resources marshaled, there is no reason to believe that because efficiency is a desirable effect of good lawmaking that it should be the paramount goal of lawmaking generally.

over wages today is far more a matter of applied mathematics than one of contemporary philosophy.

78. Avoiding any discussion of existing racial inequality at t₁ that led to the present condition at t₂ is a continuing trend, supposing that every point in time is distinct and magically separate from the events that came before. See Daniel Patrick Moynihan, Dept of Labor, The Negro Family: The Case for National Action (1965); see also Parents Involved in Cmty. Sch. v. Seattle Sch. Dist. No. 1, 551 U.S. 701, 748 (2007) (“The way to stop discrimination on the basis of race is to stop discriminating on the basis of race”).


81. The most extreme view is one that, even if efficiency were adopted as the sole purpose for law, law could not serve this purpose. “The basic features of ecosystems and markets are not controversial. No one versed in the ways of these systems would seriously propose to control the population of butterflies or the price of duct tape. Yet result-oriented measures and practices have become commonplace, not because the systems are misunderstood but because the role of law is misconceived. Law is not able to dictate how . . . markets operate.” Bruce Pardy, The Hand Is Invisible, Nature Knows Best, and Justice Is Blind: Markets, Ecosystems, Legal Instrumentalism, and the Natural Law of Systems, 44 Tulsa L. Rev. 67, 67 (2008).


83. Jon D. Hanson & Melissa R. Hart, Law and Economics, in A Companion to Philosophy of Law and Legal Theory 311-12 (Dennis Pattersen ed., 1996) (noting that a “vast majority of law and economics scholarship assumes without hesitation that the goal of law should be efficiency”).
B. The Evolving Concept of Subsidy in Law and Economics

A subsidy, in the broadest sense, is a payment (or tax reduction) from the government made with the intent to change the characteristics of a particular market or set of markets. For instance, allowing the price of a commodity to fall below net production cost enables the indigent to buy goods and services without having to resort to begging or crime. Subsidies are generally meant to incentivize positive behavior, whether from market actors or from individual citizens.\(^84\) The conservative law and economics opposition to subsidies like welfare comes more from the lack of confidence that markets (and individuals) can be managed through specific incentives\(^85\) than from an opposition to the concept of welfare in the abstract.\(^86\) More specifically, many conservatives question whether the self-interest and the public interest can be well enough aligned\(^87\) to achieve broader goals in the marketplace.\(^88\) Because this is a reasonable and discretely defensible position,\(^89\) this welfare position has acted as a secure "home base"\(^90\) for other theories and proposals.\(^91\)

C. Bank Bailouts and Nouveau-Interventionism: What Would Chicago Do?

One of the largest subsidy plans of this young century has been the decision for the federal government to become an equity stakeholder in the nation’s banking system.\(^92\) This bailout may well run counter to

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84. To encourage people to "work hard and play by the rules," as President Bill Clinton once said. President’s Radio Address, 31 WEEKLY COMP. PRES. DOC. 31-32 (Jan. 7, 1995).
87. For a classic piece on the difficulty of managing incentives, see Steven Kerr, On The Folly of Rewarding A While Hoping For B, 9 ACAD. MGMT. EXECUTIVE 7 (1995).
89. The author is speaking here about the question of whether markets or people can be managed with incentives, which often have unintended side effects.
91. See generally Amy L. Wax, Norm Change or Judicial Decree? The Courts, the Public, and Welfare Reform, 32 HARV. J.L. & PUB. POL’Y 45 (2009).
the traditional law and economics reason for efficiency, that downstream effects will be generally pro-consumer, principally in the form of lower prices for goods and services. How much the bailout plan costs in the long-run is less the issue, but its underlying methodology - particularly with a constitutional law professor from the University of Chicago in the White House - is far more interesting.

Early in the financial crisis, the Obama Administration crafted a plan for the federal government to buy so-called “toxic” assets held by major banks. The Obama Administration later abandoned this “offloading” policy for an “equity” policy where the banks would retain ownership of their undesirable assets, but still be able to raise capital from the government in a firm-to-shareholder relationship.

To understand the financial crisis, one must understand the ends of Bear Stearns and Lehman Brothers, which in retrospect look like a comparison between first-world and third-world emergency medicine. Bear Stearns received assurances that, at an absolute minimum, its donated vital organs would live on within JPMorgan Chase.

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96. Eric Posner and 2008 Nobel Laureate Paul Krugman were quick to criticize the plan. Krugman wrote, “Financial institutions that want to “get bad assets off their balance sheets” can do that any time they like, by writing those assets down to zero — or by selling them at whatever price they can. If we create a new institution to take over those assets, the $700 billion question is, at what price? And I still haven’t seen anything that explains how the price will be determined.” See Eric Posner, Why should the government buy toxic assets?, http://www.volokh.com/posts/1232381598.shtml (Jan. 19, 2009).


versely, Lehman Brothers was left to drown in its own blood. Al-
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most nowhere does the idea of a monolithic, single opinion in law and
economics seem more ludicrous than in the operating rooms where
corporations die: the bankruptcy courts. The effect of differing eco-
nomic theories in the bankruptcy courts affects even healthy firms;
firms negotiating with sophisticated creditors are influenced by the
economics of how a bankruptcy would unfold, even if the firm never
files for bankruptcy.

The application of law and economics principles to bankruptcy ap-
pears to span the entire philosophical spectrum. Some believe that
bankruptcy courts are market entities competing for business, others believe that bankruptcy is an efficiency mechanism optimized
around sorting out pre-existing obligations, while still others believe
bankruptcy courts are chiefly disruptive mechanisms. There are, of
course, views farther to the periphery expressed in the scholarship
that law and economics principles dictate that Chapter 11 is either
wholly obsolete or a species of structured larceny. One thing is
certain: there are inefficiencies, agency costs, and interim losses ab-
sorbed by parties and non-parties to a bankruptcy that are not mea-
sured by the traditional law and economics approach. Job losses,

See Nathalie D. Martin’s 1998 article does an excellent job examining this issue in depth. See Nathalie D. Martin, Noneconomic Interests In Bankruptcy: Standing on the Outside
interim unemployment periods, and workers who cannot apply their extant skill set to a new job, for example, all carry costs the society must absorb. These costs are visible only if the bankruptcy is examined from non-creditor perspectives; they are invisible to creditors, as most creditors will have vantage points on the bankruptcy similar to each other. The Jacksonian creditor view is where the bankruptcy is a process for creditors to buy greater clarity or certainty as to their proceeds and excludes third-party costs by creating the illusion of a bilateral exchange. Pretending that a creditor trades part of his possible dollar for a certain return of twenty-five cents is to pretend that the dollar existed in the first place. This fiction is a dangerous one, as it supports the fallacy that the creditor and the debtor are still dealing directly and are in a position to draw their own terms when they are actually in an extra-market artificial space.

Bankruptcy is one of many areas of law where the traditional, straightforward application of microeconomic principles to law and economics problems has begun to break down. The disagreement over how to handle, ignore, or factor in these systemic costs is one of the most important wedges cracking the consensus among law and economics scholars. Specifically, when costs are imposed by a single party on an opposing party and costs will surely be borne by a third-party not represented, how can one insure this third-party does not pay excess rents or become overburdened with what should be the opposing party's costs? Further, is it relevant whether the costs are pecuniary, health, environmental, diplomatic, present or measurable?

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109. There is some momentum in the law and economics movement toward using market rate or auction rate valuations rather than judicial valuations in bankruptcy. This momentum has thus far, however, mostly stayed safely contained in the scholarship and away from the bench. See, e.g., Robert K. Rasmussen & David A. Skeel, Jr., The Economic Analysis of Corporate Bankruptcy Law, 3 Am. Bankr. Inst. L. Rev. 85, 93-94 (1995).

110. "Opposing party" is used here to mean in litigation, in negotiation, or as a counterparty to contract.

111. "Present" is used here as a measure of temporal proximity, as in present costs versus deferred or not yet extant costs.

112. "Measurable" is used here to mean quantifiable in economic terms.
V. The Modern Era: The Myth of Consensus Shatters

Rather than a learning,\(^{113}\) evolving network, the law and economics community turned into a Balkanized muddle in 2009. During the 2008-09 bailout,\(^{114}\) even Reagan-era law and economics voices were not speaking in unison.\(^{115}\) Similarly, during the 2009 debate over whether there should be a “public option” in the health insurance market, many law and economics scholars of the old and new generations\(^ {116}\) disagreed.\(^ {117}\) Unfortunately, this momentary fracture in the

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\(^{113}\) For law and economics to remain a favored approach, it must outperform other approaches. See generally Peter M. Senge, *The Leader’s New Work: Building Learning Organizations*, SLOAN MGMT. REV., Fall 1990, at 7 (citing collective learning in organizations as modern source of competitive advantage).

\(^{114}\) This is part of a troubling, continuous cycle that has been seen in the mining industry, the steel industry, the airline industry, and now the banking industry. Capital markets cannot exist without the state. When markets exhaust available credit, capital, and resources, the state bails out the industry in question. Then, once the industry is bailed out and prosperous, there is a push for the very deregulation that enabled an accumulation of risk in the sector in the first place.

\(^{115}\) Kathryn Spier and John C. Coates at Harvard, both of whom exited graduate school around the time Reagan exited office, have voiced a variety of opinions on the current financial industry predicament. Spier, a former visiting professor at the University of Chicago Booth School of Business and Olin Fellow at the University of Chicago Law School, focuses her recent scholarship on insolvency and bankruptcy; law and economics scholars viewing the crisis through this lens may have more difficulty parsing Bear Stearns-style outcomes than Lehman Brothers “do not resuscitate” outcomes. Coates was initially skeptical of the bailout plan, doubting bailout funds would reach lending operations within large banks. For a webcast video describing Coates’s early thoughts on the plan, see John C. Coates, *How “The Bailout is Robbing the Banks,”* http://www.law.harvard.edu/news/spotlight/business-law/related/07_bailout.html (May 8, 2009). He has since (in his July 29, 2009 testimony before the Senate Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance and Investment and in related written testimony) focused on the problem within banks being procedural (his recommendations now include considering separating the Chairman and CEO positions at large firms, for instance) and incentives-centric rather than focusing on internal inefficiencies or intra-organizational resource allocation problems.

\(^{116}\) The new generation here refers to the generation after Becker and Posner, scholars whose graduate school experiences came under a Republican administration, during the Reagan era or in the post-Reagan Bush years.

law and economics phalanx fostered less intellectual heterogeneity than one might expect.

A. When Things Got Blurry

While law and economics may well be "arguably, the most important development in legal scholarship in the last hundred years," what law and economics stands for, or should stand for, is an open question in the current environment. The late 1990s yielded a few voices of dissent, notably from Professor Nussbaum at the University of Chicago. These writings went beyond the earlier, tamer critiques in scholarship from the Reagan era.

Still, none deal directly with dismantling the central myth of law and economics: the efficient bilateral exchange. The reason the actor in the law and economics devotees' hypotheticals can contract around problems and inefficiencies is simple: this actor is magically familiar with the single counterparty or group of constituent counterparties with whom to contract. However, this ignores the types of bargains that are not well-suited to bilateral dealing. In many situations, the parties to be dealt with are either too numerous or too uncertain to be bargained with. In other situations, a market-clearing price would have within it what many law and economics scholars would consider unacceptable inefficiencies.
B. Does Richard Posner Love Anacott Steel?  

The regulation of insider trading, or lack thereof, continues to be a difficult question in the law and economics universe. Fundamental premises remain in dispute, as some scholars in the area view insider trading as a beneficial activity, while others see insider trading as harmful, hurting the integrity of equity prices and (if seen in great volume) the liquidity of markets. Even economists with similar academic backgrounds and similar policy goals, who agree that efficiency is a central goal of laws and market regulations, cannot agree whether insider trading increases or decreases efficiency. Nor can legal scholars agree as to what degree even narrowly-defined opportunities for insider trading should be policed on efficiency or other grounds.

An interesting facet of the insider trading debate is its core similarity to the welfare debate and the healthcare debate: many wonder whether the public interest can be well-aligned with the incentives given to individuals. Various scholars argue that allowing insider trading creates a distraction, increases risky behavior, and encour-

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126. With apologies to Stanley Weiser and Oliver Stone. Anacott Steel is the name of a fictional company in the film WALL STREET (20th Century Fox 1987).
131. See id. at 237-40 (summarizing the traditional arguments presented by Coase and others).
133. See generally Boyd Kimball Dyer, Economic Analysis, Insider Trading, and Game Markets, 1992 Utah L. Rev. 1 (theorizing that managers would become more focused on trading than on managing operations); cf. OLIVER E. WILLIAMSON, CORPORATE CONTROL AND BUSINESS BEHAVIOR: AN INQUIRY INTO THE EFFECTS OF ORGANIZATION FORM ON ENTERPRISE BE-
ages corporate officers to attempt to manipulate the market through news\textsuperscript{135} or other avenues.\textsuperscript{136} What is really at issue, however, is who might be a party to the transaction. If one believes the executive involved in the trade and the person from whom the executive buys the stock (or sells it to) are the only parties, then it is a bilateral transaction in need of little analysis beyond whether the statutes in force at that time permit the trade. If, however, one believes the firm’s other shareholders, the firm’s bondholders, the exchange on which the firm trades, and society at large are parties potentially affected by the transaction, one may be more reluctant to approve of insider trading.\textsuperscript{137}

\textbf{C. Contract Around Baby Right Round}\textsuperscript{138}

If it is possible to routinely contract around scenarios such as class action litigation and bankruptcy, then these types of proceedings should be ground zero for these complex contract maneuvers. The problem here is twofold: (1) attorneys with litigation experience are skilled at settlement, which is distinguishable from dealmaking,\textsuperscript{139} and (2) outside financing is almost always needed to make the bargain mutually acceptable.\textsuperscript{140} Hence, even though class actions and bankrupt-

\begin{footnotesize}
\textsuperscript{138} With apologies to Pete Burns. \textit{Dead or Alive, Youthquake} (Epic 1985).
\textsuperscript{139} Dealmaking here refers to business negotiations where the parties’ relationship is defined by a mutually beneficial bargain of pecuniary value. This is different in many ways from settlement negotiations where the parties are linked by an interest in accelerating the resolution of a legal dispute.
\textsuperscript{140} Even within the resilient cocoon of bankruptcy protection, outside financing is usually needed in order for the firm to emerge with creditors satisfied. See Brian Tumulty, \textit{History Shows Corporations Can Survive Bankruptcy}, USA TODAY, June 1, 2009, \url{available at http://www.usatoday.com/money/autos/2009-05-29-gm-surviving-bankruptcy_N.htm} (quoting Randal
cies are likely not ideally efficient for both parties, they may remain the preferred (yet more inefficient) means of dispute resolution.141

Despite decades of scholarship suggesting that contracting around inefficient rules and processes should be common,142 there are few, if any, examples of a Baird-Rasmussen contract bankruptcy.143 The author has been unable to unearth a single class action with a bet-the-firm dollar value144 that was resolved in a Baird-Rasmussen-esque negotiation rather than through traditional settlement negotiations or mediation processes.145 Nor are there any Harvard Business School case studies146 where a stated strategy or proposed solution is to contract around an imminent legal process, the goal being to avoid exposing the firm to judgment creditors or creditors in bankruptcy.

VI. TWO OF MANY BLIND SPOTS

Since the mid-1990s, many important innovations in investments and finance have come from politically progressive economists, entrepreneurs, and financial institutions. These innovations include microfinance and socially-responsible investing and are part of a growing network of financial products, institutions, and practices that

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141. For commentary regarding why a party might fail to contract around a rule or process that is not ideal, see Russell Korobkin, The Status Quo Bias and Contract Default Rules, 83 CORNELL L. REV. 608, 670-76 (1998).


144. In other words, a lawsuit with a value representing a substantial portion of the market capitalization of the firm in question.

145. This may have to do, in part, with how the firm views itself – as a repository for shareholder value or, instead, as a managerial or operational hierarchy. See William W. Bratton, Jr., The New Economic Theory of the Firm: Critical Perspectives from History, 41 STAN. L. REV. 1471, 1475-76 (1989). But see Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 COLUM. L. REV. 1416, 1422-28 (1989). In either case, there are disincentives associated with unconventional private contract resolution.


147. Note that this concept of "contracting around" a legal process entirely is different from reaching a settlement acceptable to the various parties.
would not have arisen from the usual law and economics efficiency-centric analysis.

The current neoliberal law and economics movement is focused on a small universe of concepts applied broadly, rather than a large universe of ideas with applications particular and peculiar to the problem at hand. As a result, many ideas are in the “blind spot” of those who have internalized classic law and economics assumptions. The very brief discussion, infra, is meant to provide two examples of ideas and solutions that likely would not be reached through traditional law and economics approaches, rather than detailed explanations of each. This discussion’s purpose is to show that these law and economics “blind spots” are not only interesting in the abstract, but also detrimental in practice to working economists and institutions.

A. Microcredit

Despite years of discussion in the neoliberal scholarship about empowering the poor\(^\text{148}\) rather than merely distributing assets to them through government social programs and taxation, the idea of a microfinance system\(^\text{149}\) driven by social business\(^\text{150}\) did not emerge\(^\text{151}\) from the neoliberal establishment.\(^\text{152}\) Instead, microfinance institutions sprouted from the regions and markets that needed them most,\(^\text{153}\) not because of government intervention\(^\text{154}\) or teams of for-


Microfinance, as a trend and an industry, continues to grow, creating a new body of scholarship and attracting top talent.

The hurdle that prevented microfinance from being practicable for most of Western history—high transaction costs—was removed in the latter part of the twentieth century by automation, the Internet, and more efficiency around small transactions both within countries and internationally. Not surprisingly, the neoliberal law and economics establishment that discounts the importance of transaction cost in other areas did not notice when transaction costs dropped to a point where sustainable large-scale microfinance was feasible. This may explain, at least in part, the failure of the law and economics community to notice the potential and scalability of microfinance models until rather late in the game.

B. Social Investment

The concept of social investment (socially responsible portfolio management on the funds side; social venture investing on the private equity and venture capital side) is one of alignment: better aligning the investor's interests with the interests of the corporations' in which he or she invests capital. Despite being an apparently simple, bilateral exchange causing better incentive alignment, this type of investing


157. Grameen Bank, a leading microfinance institution, was founded by Mohammad Yunus, a Bangladeshi economist with whom it shares a 2006 Nobel Prize. Grameen continues to recruit top talent, including Paul Maritz, CEO of VMware Corporation and a former senior Microsoft executive who now serves as Chair of the Grameen Foundation. See Grameen Foundation, Board of Directors, http://www.grameenfoundation.org/who-we-are/people/board-of-directors (last visited Jan. 5, 2010).

158. Both bilateral exchange models and positive incentive correlation are favored by the neoliberal law and economics movement, as discussed supra. In addition, investors' increased awareness and education about the operational realities of the firms in which they invest should bring more information into the market, creating more accurate price levels for equities. However, many neoliberals were slow to warm to socially-responsible investing, possibly due to its philosophical connection to environmentalism (a source of regulatory inefficiency), despite environmental concerns being only one of many concerns socially-responsible portfolio management might address (labor standards in countries playing host to major operations, treatment of workers, equity structure, bonus structure, internal incentives, executive compensation, handling of products liability litigation being other examples).
was seen as an inefficient curiosity by many in the establishment, an artifact of mid-1990s dabbling by liberal trustifarian twenty-somethings and the dot-com naïfs. Now, the industry around socially-responsible investing has grown substantially (to over two trillion U.S. dollars) and continues to grow each year.\textsuperscript{159} Funds using socially-responsible screens\textsuperscript{160} still have much room to grow, representing just over 2\% of mutual fund assets in the United States three years ago.\textsuperscript{161} Still, many in the law and economics movement have shown little interest\textsuperscript{162} in the area of socially-responsible\textsuperscript{163} investing.\textsuperscript{164}

The majority of law and economics scholars failed to see this trend until it was well-established, at least in part, because mainstream (which is to say neoliberal) law and economics scholars look narrowly at economic efficiency, specifically efficiencies achieved in bilateral dealing. When conceiving of bilateral counterparty relationships, an economist considers a group of parties in subsets of two, in pairs, with all benefits and efficiencies accruing to the counterparties. Because of this bilateral conception bias, preferences of third parties and harm to

\begin{itemize}
  \item \textsuperscript{160} A "screen" is the industry term for a filter the investor or fund manager places to limit investments in a given portfolio, segment, or allocation. For instance, an investor might only want to invest in domestic companies if they do not have a substantial history of minimum wage violations. The firms excluded by their past minimum wage violations would then be "screened" and not permitted to be part of the investment strategy, even if these firms presented strong financials or appeared to be a good value.
  \item \textsuperscript{161} Jonathan Dee, \textit{A Toy Maker's Conscience}, N.Y. TIMES, Dec. 23, 2007 § 6, at 34.
  \item \textsuperscript{162} Rather, the central figures of the law and economics movement have consistently pushed the needle to the other end of the gauge, demonstrating their indifference to the social implications of economically-efficient models, whether auctioning babies (as a replacement for the adoption process), legalizing dueling (as an economically-efficient dispute resolution methodology), or allowing women to auction their right to choose (selling abortions as a bid-to-exercise option contract, where churches, boyfriends, and others would try to outbid one another, determining whether the option of abortion was exercised). See, e.g., Richard Posner & Elisabeth M. Landes, \textit{The Economics of the Baby Shortage: A Modest Proposal}, 7 J. LEGAL STUD. 323 (1978). Given these positions, it would be logically inconsistent to not support, for instance Natalie Dylan's right to auction her virginity on eBay in 2008. \textit{Student Auctions Virginity, Sparks Online Debate}, REUTERS, Sept. 11, 2008, http://www.reuters.com/article/newsOne/idUSSP12411420080911. \textit{But see} Miriam R. Albert, \textit{E-Buyer Beware: Why Online Auction Fraud Should Be Regulated}, 39 AM. BUS. L.J. 575, 614 n.175 (2002). \textit{See also} \textit{Virginity Auction Ends On Net}, BBC News, Feb. 9, 2004, http://www.newsbbc.co.uk/1/hilengland/bristol/3473817.stm; \textit{Web Suitor Bids £251,000 for Bride}, BBC News, Jan. 29, 2002, http://news.bbc.co.uk/1/hilengland/1788714.stm.
  \item \textsuperscript{163} The University of Chicago Booth School of Business does not offer, and has never offered, a portfolio management or finance course focused on investments made in deals or firms that are socially-responsible.
  \item \textsuperscript{164} Fuller-Thaler, an investment firm with Professor Richard Thaler of the University of Chicago on its investment team, lists its seven investment strategies on its website, none of which consider the social responsibility of the investments made. \textit{See Fuller & Thaler}, http://www.fullerthaler.com/people/richard-thaler.aspx? (last visited Jan. 5, 2010).
\end{itemize}
third parties are not a major consideration; hence, social responsibility as to third parties has not been a major consideration of neoliberal law and economics work.

VII. THE BIRTH OF A HETERODOX LAW & ECONOMICS MOVEMENT

The existing law and economics movement has spread from areas where there is a clear interplay between law and economic issues (property\textsuperscript{165} and contract law\textsuperscript{166}), to areas where the use of economic principles to solve legal questions is less obvious (adoption and bankruptcy\textsuperscript{167}), and finally to areas that are primarily political questions or matters of policy (whether insider trading should be legal, whether a merger or acquisition should receive additional scrutiny, how many choices a health care plan should include). So pervasive is the global influence of law and economics that there is a Department of Economic Law at Beheshty University in Iran.\textsuperscript{168} Meanwhile, the law and economics movement has lost sight of a greater concept of equity\textsuperscript{169} and heavily discounted the soft inputs\textsuperscript{170} that might make a world seen through a “law and economics” lens more realistic.

The staunchest supporters of law and economics today believe economic calculations will supplant the history, social norms, and precedent that shape law today. However, the very issues law and economics seeks to minimize or ignore are those it does not ade-

\textsuperscript{165} For a recent example of a court applying law and economics principles, see Burns v. PA Dep’t of Correction, 544 F.3d 279, 289-90 (3d Cir. 2008) (appellate court attempting to derive utility and value from facts; noting that “the ‘language of economics’ is not simply useful but highly germane because it allows us to objectively measure and describe the economic result of a particular action”).


\textsuperscript{167} While the resolution of a bankruptcy is most certainly an economic activity, bankruptcy occurs within the protection of specialized, codified rules and state laws, not within a market environment. See Charles J. Goetz, Cases and Materials on Law and Economics 128-29 (1984).

\textsuperscript{168} Yadollah Dadgar of Beheshty University, who keeps a working paper entitled Law and Economics from a Moderate Islamic [P]erspective, and others in the near east have explored applications of law and economics in recent years. See Yadollah Dadgar, Law and Economics from a Moderate Islamic Perspective (UC Berkeley, Program in Law and Econ., Working Paper, 2009), available at http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1241&context=blewp.

\textsuperscript{169} Eric K. Yamamoto, Efficiency’s Threat to the Value of Accessible Courts for Minorities, 25 Harv. C.R.-C.L. L. Rev. 341, 356 (1990) (noting that many have criticized law and economics scholars for associating “efficiency” with “fairness,” when the two are often not correlated positively).

quately describe, such as considerations of equity,\textsuperscript{171} unforeseen harm to third parties, and scenarios in which the underlying rational choice assumption falls apart.\textsuperscript{172} So long as law and economics remains a method for examining\textsuperscript{173} legal rules\textsuperscript{174} rather than becoming a new set of rules in itself, the current role of law and economics will likely have a positive effect. Beyond the judiciary, where this framework cannot account for the range of operative variables, the application of neoliberal law and economics principles offers diminishing utility. In these places, the use of law and economics of any flavor or political persuasion as a universal explanation for human or market behavior must be circumscribed.

There must be a push to adjust and perfect models rather than merely discounting the importance of their flaws. The sometimes-difficult-to-quantify realities of the world, including the large burden of transaction costs and the possibility of harm to third-parties, must have a place in future models if these models are to offer maximum utility. Lastly, the actor in question cannot be replaced by the rational actor as easily as one replaces the actor with the reasonable person in common law tort. The world of law and economics must value authenticity over simplicity, accuracy over art, and must depict a place where different actors are motivated by different incentives—not all of which are rational, proportional, or reasonable.

\textsuperscript{171} Ian Ayres, \textit{Playing Games with the Law}, 42 STAN. L. REV. 1291, 1315-16 (1990) (illustrating, using game theory, that various conditions with positive effects on the health of a market do not have positive effects on related social welfare factors).

\textsuperscript{172} For instance, if the operative assumption is that all actors are rational, it becomes quite challenging to create working models for criminal law, given the inherent limits of the law and economics toolbox. See William J. Barnes, Jr., \textit{Revenge on Utilitarianism: Renouncing a Comprehensive Economic Theory of Crime and Punishment}, 74 IND. L.J. 627, 628 (1999).

\textsuperscript{173} Note that “examining” is materially different from “interpreting.” While it is appropriate to test and experiment with legal rules using economic analysis, economic principles should not be used to interpret laws that were not crafted with economic considerations in mind. See John Cirace, \textit{When Are Law and Economics Isomorphic?}, 39 GOLDEN GATE U. L. REV. 183, 214 (2009) (“[I]f a court adopts the goal of efficiency as its guide in cases . . . law and economics will be isomorphic because judges will tend to interpret legal concepts consistently with economic concepts”).
