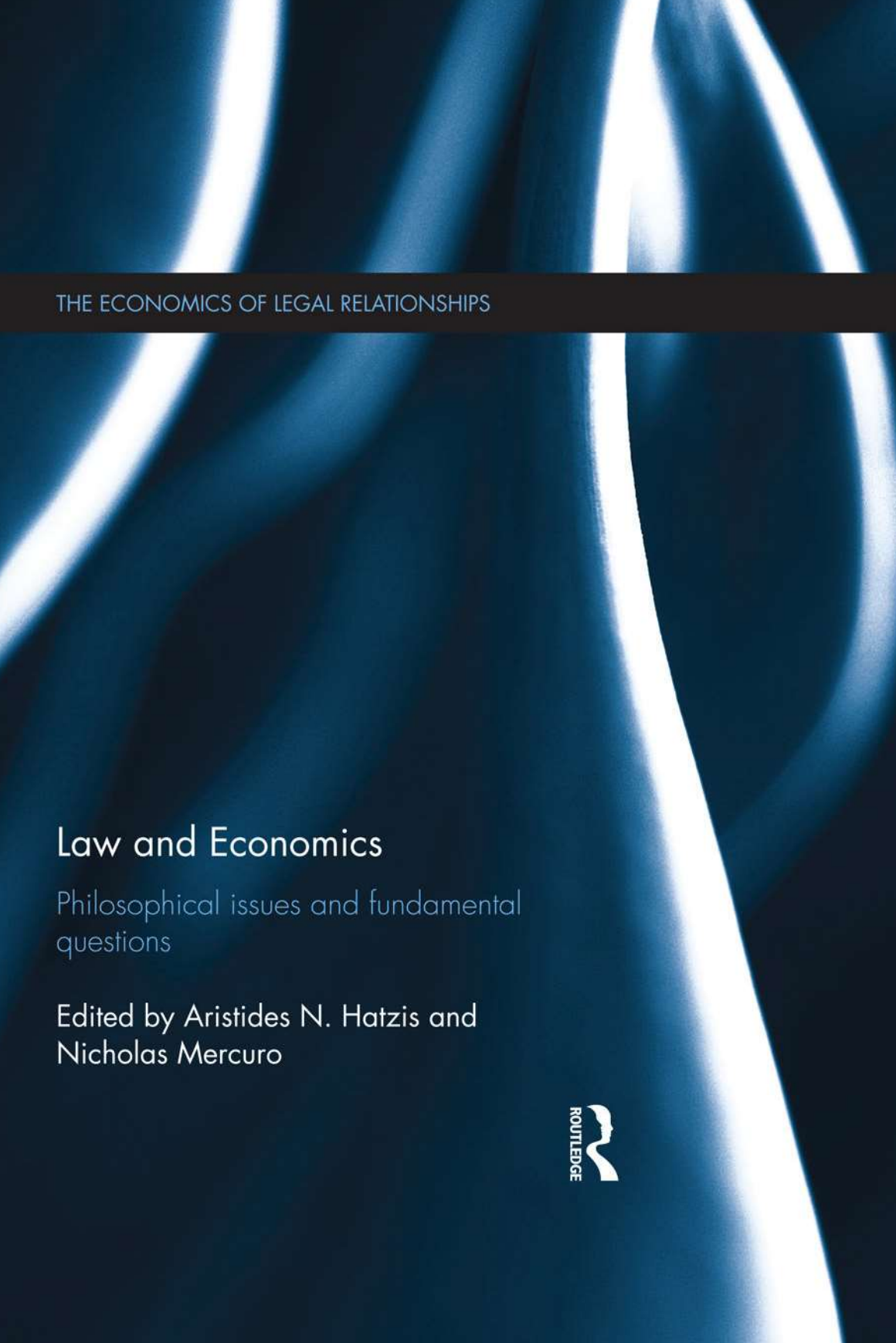
THE ECONOMICS OF LEGAL RELATIONSHIPS
Law and Economics
Philosophical issues and fundamental questions
Edited by Aristides N. Hatzis and Nicholas Mercuro
ROUTLEDGE

Law and Economics

The Law and Economics approach to law dominates the intellectual discussion of nearly every doctrinal area of law in the United States and its influence is growing steadily throughout Europe, Asia, and South America. Numerous academics and practitioners are working in the field with a flow of uninterrupted scholarship that is unprecedented, as is its influence on the law.

Academically, every major law school in the United States has a Law and Economics program and the emergence of similar programs on other continents continues to accelerate. Despite its phenomenal growth, the area is also the target of an ongoing critique by lawyers, philosophers, psychologists, social scientists, even economists since the late 1970s. While the critique did not seem to impede the development of the field, it certainly has helped it to become more sophisticated, inclusive, and mature. In this volume some of the leading scholars working in the field, as well as a number of those critical of Law and Economics, discuss the foundational issues from various perspectives: philosophical, moral, epistemological, methodological, psychological, political, legal, and social.

The philosophical and methodological assumptions of the economic analysis of law are criticized and defended, alternatives are proposed, old and new applications are discussed.

The book is ideal for a main or supplementary textbook in courses and seminars on legal theory, philosophy of law, jurisprudence, and (of course) Law and Economics.

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Preface

There is no approach to law that is more influential in the United States today than Law and Economics; in economics departments, it is a standard course offering. The literature in the field continues to influence the intellectual discussion of nearly every doctrinal area of law. Outside of the United States its ideas and impact on law grow steadily.

It has been more than 40 years since the publication of Richard Posner's *Economic Analysis of Law*, the book that helped launch the Law and Economics movement. The ninth edition of the book was published in early 2014, this time competing against over thirty textbooks, edited collections, and casebooks on Law and Economics. Today, law review articles that incorporate the "economic way of thinking" are numerous; economics departments and law schools routinely offer at least one Law and Economics course; and major law schools feature well-funded and well-established Law and Economics programs/centers. The ideas and concepts that constitute Law and Economics are now being transmitted to successive generations of graduates in both economics and the law.

This is no doubt a success story, especially in the legal academia where the change of paradigms is not exactly a frequent occurrence given the fact that doctrinalism continues to hold sway. And one must not forget that all of this happened even though Law and Economics initially faced an unprecedented attack by almost everyone in American and English legal theory. If not formally marginalized, Law and Economics scholars created a tension among their doctrinally trained colleagues who were left wondering what exactly did Pareto Optimality, Kaldor–Hicks efficiency, and welfare economics have to do with their "law". Thirty five years ago, in the famous "twin symposia" on "efficiency" and "wealth maximization" in legal theory (*Journal of Legal Studies*, 9:2, March 1980 and *Hofstra Law Review,* 8:3–4 Spring-Summer 1980), the foundational assumptions and the deductive approach proffered by Law and Economics was harshly criticized and its future seemed somewhat uncertain. Nobody could have anticipated that it would move forward against this full-scale attack. A look back suggests that those practicing Law and Economics have proven to be quite resilient and adept at surviving.

Today, even though Law and Economics remains somewhat controversial, it is now securely niched within the legal academy. Those working in the field are

busy producing an immense body of work – in the contiguous subdisciplines of New Institutional Economics, Public Choice Theory, Behavioral Law, and Economics, even Austrian Law and Economics – some of which pushes back on the early assumptions and models based on rational choice. It now exerts an even greater influence if only by its sheer volume.

But fundamental questions remain: Is Law and Economics a utilitarian, market-friendly legal theory? Or is it a new legal paradigm which, despite its intellectual debts, has managed to realize the promise of Sociological Jurisprudence and Legal Realism? … Or is it both?

More than fifty years after the formulation of the Coase theorem and Guido Calabresi's work on torts; forty years after the presentation of the Posnerian research program, and thirty five years after Henry Manne began his Economics Institute for Law Professors and Law Institutes for Economics Professors, the movement is now distinctly different yet at the same time less controversial and, dare we say, almost mainstream. Because of this, we thought the time had come to revisit the question of values in Law and Economics. We were interested in what others thought about such questions as: What are the norms and values underlying this impressive body of research? … and … What are the philosophical issues and fundamental question confronting this evolving discipline? We were fortunate enough to solicit contributions from those in Anglo-Saxon and continental legal theory and some of the leading experts in Law and Economics from various generations and representatives from different schools of thought. We are grateful for their willingness to participate and hope this book continues to solidify the field within the legal academy.

Aristides N. Hatzis and Nicholas Mercuro
January 2015

12 Moral externalities

An economic approach to the legal enforcement of morality

*Aristides N. Hatzis**

Morality arises from market failure.

David Gauthier[1]

Introduction

One of the major issues in moral, political, and legal philosophy is the question of legislating morality.[2] It is quite obvious why this has always been, and still is, a hot issue: law was inseparable from religious and social morality for the greatest part of human history – and it still is in some areas of the world. Legal rules regularly reflected conventional morality, used sanctions as a deterrent for anyone who didn't conform to society's moral standards and reinforced social morals by authentically "expressing" the society's general will and by educating citizens in the process of socialization. These expressive and educative functions of the law are still considered important by both politicians and lawyers (Sunstein 1996; McAdams 2000a; 2000b), even in legal systems where positivism is dominant. Legal positivism had never managed to wipe out the overwhelming influence of morality to law, especially to criminal law, but also in more unlikely areas such as contract or tort law (Dyzenhaus *et al.* 2007). Today, even in the most liberal criminal law systems, social morality still plays a major, if contained, role. A number of human acts, behaviors, lifestyles, and choices are still categorized as "crimes" despite the fact that the individuals involved have genuinely consented to these acts and there seems to be no harm to anyone involved or other reason related to the public interest for their criminalization – other than an explicit or implicit application to social morality.

This very close relationship of law and morality is not, of course, unreasonable. Even the staunchest positivist would admit that all the major crimes are also immoral acts: murder, rape, robbery, assault, blackmail, etc. are all crimes what are also considered immoral by the great majority of citizens in the liberal secular democracies. The consensus for the criminalization of such acts is so broad that one could be tempted to use it as a criterion that is both democratic and welfarist. An act that is considered immoral by the great majority of citizens in a democratic society should definitely be prohibited and criminalized if we are to respect the democratic (majoritarian) principle. Its prohibition will supposedly

satisfy the same majority of citizens, thus increasing social utility by diminishing the disutility of people morally offended by certain types of behavior.

The democratic and the utilitarian arguments for the legal enforcement of conventional morality are interrelated and intuitive. They are also politically powerful. A moralistic public policy is usually popular, especially in more traditional societies. On the other hand, a liberal policy of acknowledging or establishing rights for minorities or individuals very often sounds counterintuitive and conflicts with moral intuition,[3] reflecting social morality. The opposition to liberal policies is fiercer where these rights protect behavior that is considered immoral by the society-at-large. These policies are treated as anti-democratic, especially if they have been promulgated by the courts in spite of referenda or the decisions of legislative majorities. The courts in all these cases are accused of being anti-democratic, activist usurpers of political power rightfully belonging to the legislator and the people (Bork 2003). On the other hand, the references to the utilitarian argument are not so common in everyday political discourse. It is mostly used indirectly, implicitly or in special cases with references to the concepts of "public interest" and (as unlikely as this may sound) "human dignity."[4] These two concepts are the two more popular vehicles for the enforcement of moralistic and paternalistic policies.

In this chapter I am going to briefly present the debate on the legal regulation of morality. I am going to present the harm principle as it was famously defined by John Stuart Mill, not only as a principle for a liberal objective criminal law, but as a guiding principle for political liberalism. I call Mill's principle the "liberal principle" to differentiate it from the "democratic principle" of majoritarian collective decision-making. Even though these two principles are antagonistic in contemporary liberal democracies, they also have a symbiotic relationship. After discussing briefly the critiques to the liberal principle by legal paternalists and legal moralists, I will introduce an additional argument in favor of a moralistic view of law, the "moral externalities" argument. As we are going to see, this is a quite powerful and interesting argument which is based on amoralistic grounds and it is defended by major law and economics scholars, among others. I am going to link this argument to the argument for the impossibility of Paretian liberal (Sen 1970; 1976) and the traditional moralistic arguments developed by philosophers and lawyers (Stephen 1993 [1873]; Devlin 1977). I will try to rebut these arguments by defending a narrow version of the right to self-ownership based on the Coase theorem as this was reconstructed and used by Richard Posner and Guido Calabresi.

From the harm principle to the paradox of liberal democracy

The harm principle was famously stated by J.S. Mill in his 1859 book *On Liberty*:

> [T]he sole end for which mankind are warranted, individually or collectively, in interfering with the liberty of action of any of their number, is

> self-protection. That the only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others. His own good, either physical or moral, is not a sufficient warrant. He cannot rightfully be compelled to do or forbear because it will be better for him to do so, because it will make him happier, because, in the opinions of others, to do so would be wise, or even right. These are good reasons for remonstrating with him, or reasoning with him, or persuading him, or entreating him, but not for compelling him, or visiting him with any evil in case he do otherwise. To justify that, the conduct from which it is desired to deter him, must be calculated to produce evil to some one else. The only part of the conduct of any one, for which he is amenable to society, is that which concerns others. In the part which merely concerns himself, his independence is, of right, absolute. Over himself, over his own body and mind, the individual is sovereign.
>
> (Mill 1859: I.9)

There is, of course, a rich literature which is trying to interpret harm (Feinberg 1984–1988; Wertheimer 2002). Does this include extreme offence? Does it include negative externalities? (Trebilcock 1993; Hatzis 2006, 2015). Could we add collective action problems to the cases where the government should limit liberty? Is this view compatible with social contract theories? Independently of the answer to these questions I should emphasize the essence of this argument: There is a presumption of personal freedom; the burden of proof for the necessity for restrictions to personal freedom always lies with the government.

One could restate this principle as the (Individual) Liberty Principle. According to Mill the real issue here is not to find a guideline for criminal law. The important question (the "vital question of the future") is what are the nature and the limits of "the power which can be legitimately exercised by society over the individual" (Mill 1859: I.1). This question is not as easy to answer in a democratic society where political decisions are taken collectively by a majority or a popular government. In these cases "the rulers should be identified with the people" and "their interest and will should be the interest and will of the nation. The nation did not need to be protected against its own will" (Mill 1859: I.3). When there is a disagreement, a decision by a majority ensures political legitimatization since the democratic decision-making process is the most compatible with freedom and political equality. This is called the democratic principle which, as is well known, was devised in ancient Athens (Schmidtz and Brennan 2010: 44–50).

However,

> phrases as "self-government," and "the power of the people over themselves," do not express the true state of the case. The "people" who exercise the power are not always the same people with those over whom it is exercised; and the "self-government" spoken of is not the government of each by himself, but of each by all the rest. The will of the people, moreover,

> practically means the will of the most numerous or the most active *part* of the people; the majority, or those who succeed in making themselves accepted as the majority [...] "the tyranny of the majority" is now generally included among the evils against which society requires to be on its guard.
>
> (Mill 1859: I.4)

Mill goes so far as to suggest that the tyranny of the majority (which he calls a social tyranny) "is more formidable than many kinds of political oppression, since, though not usually upheld by such extreme penalties, it leaves fewer means of escape, penetrating much more deeply into the details of life, and enslaving the soul itself." For Mill a limit should be set to "the legitimate interference of collective opinion with individual independence: and to find that limit, and maintain it against encroachment, is as indispensable to a good condition of human affairs, as protection against political despotism" (Mill 1859: I.5)

This limit ("between individual independence and social control") should be called the "liberal principle," a principle that is necessarily antithetical to the "democratic" (majoritarian) principle. There is an area where individuals should be free to decide for themselves even when their decisions have a direct or indirect impact on society. This area is protected by rights. These rights define the area of personal freedom and autonomy where society, the majority, the government cannot intervene. What's the extent of this area? Are there any established boundaries?

Actually, in all contemporary liberal democracies it is widely accepted that there is a personal domain protected by negative rights. This domain should be shielded not only from an authoritarian government, but also from a democratic majority. This domain should be under the protection of the rule of law and its most powerful institutional weapon: the Constitution. The rule of law, individual rights, and the Constitution are all instruments of protecting both principles – the democratic and liberal principle. However, they are also instrumental in defining the domain of personal freedom, the domain where the liberal principle takes over. The liberal principle was devised and introduced institutionally by James Madison (the main author of the US Constitution of 1787) with the Bill of Rights of 1789. The First Amendment is the best example of creating a well-shielded domain of personal freedom which cannot be usurped by the government or limited by the democratic process. The controversial Ninth Amendment is illustrative of Madison's philosophy for the protection of this domain of personal freedom from the power of the majority ("The enumeration in the Constitution, of certain rights, shall not be construed to deny or disparage others retained by the people."). It is not a coincidence that this right is still awkwardly treated by most American constitutional law scholars (Barnett 1989).

In the most developed and institutionally mature liberal democracies, the boundaries between democratic decision-making and individual self-determination are well settled but, at the same time, they are in a continuing state of flux. This is so because there is an inherent ongoing clash between the democratic and liberal principles. If collective decisions is the rule in a democracy,

rights as "trumps" (Dworkin 1984) are the exception. Both principles tend to expand, one over the other. However, in most liberal democracies the liberal principle is advancing and the democratic principle is receding (for an opposing but not incompatible view, see Foley 2012). This is a movement which one could characterize as parallel, similar, or even identical with the one observed by Henry Sumner Maine two years after the publication of *On Liberty* by Mill: "[W]e may say that the movement of the progressive societies has hitherto been a movement from Status to Contract" (Maine 1861: 170). This whiggish approach to institutional development is reflected in the ongoing controversy about freeing individuals from society's authority and expanding the area of personal freedom. It is a similar movement of progressive societies from collective decisions to individual self-determination.

However, this movement cannot (and should not!) lead to the elimination or weakening of the democratic process. This would be destructive for a liberal democracy and thus detrimental to individual liberty. Even though there are a lot of cases of illiberal democracies around the world, there are no examples of liberal dictatorships or liberal "non-democracies" (whatever this might mean).[5] So a balance between these two antithetical principles should be attained. This balance is crucial for liberal democracies since it determines the quality of their rule of law (Hatzis 2014c). It is not a coincidence that countries with a high-quality rule of law and low levels of corruption have also the most extensive system of recognition and protection of individual rights and a well-functioning democratic process. I characterize this eccentric relationship of antithesis, symbiosis and balance as the "paradox of liberal democracy" (Hatzis 2014b).

Despite the fact that the boundaries between collective and individual decision making, i.e., between the domains of the democratic and liberal principle, are not given and any proposed boundaries are highly controversial, we can define a broad outline by using Mill's harm principle. Mill seems to recognize (Feinberg 1984–1988) four cases where boundaries should be drawn: harm, offence, harm to oneself, and harmless wrongdoing. This doesn't mean that there are no other instances where collective decision-making is advocated with powerful arguments (justice, need, and, most importantly, collective benefits – see Wertheimer 2002). I am not going to discuss these arguments. I am also not going to discuss, in this chapter, the related major issue of the boundaries between harm and extreme offence (but see Hatzis 2015). I will concentrate on the moralistic argument as this is curiously and interestingly connected to the democratic and welfarist (utilitarian) argument against individual self-determination.

Mill not only defined the area of permissible government interference with private choices, but also took for granted that there must be a presumption for personal freedom. Decisions by societies, majorities, and governments are residual. Even though I am quite sympathetic to (even though not totally persuaded by) this libertarian drawing of the boundaries – when individual self-determination is the rule and democratic decision-making the exception – I am

not going to defend a strong libertarian position in this chapter but only a limited right to self-ownership. It is limited in the sense that I am not going to discuss the issue of the ownership of the fruits of labor (a far more controversial and complex subject) but only the issue of the control of the body.

I am going to elaborate on the most famous normative statement of Mill's formulation: "Over himself, over his own body and mind, the individual is sovereign." According to our own limited interpretation of this statement, a sovereign individual is one who is at least able to control her own body. It's an individual that owns her own body and who doesn't need the permission of a society for anything she does with it when she doesn't harm another person with her acts. She doesn't need the permission even when she "hurts" herself or "offends" society with her harmless acts.

Legal paternalism and legal moralism

There are basically two major objections to individual self-determination. The first is based on a critique of the ontological assumption of rational individuals (Becker 1976; 2002; Stigler and Becker 1977). A rational individual can decide, presumptively, for herself better than any other individual or corporate actor can do on her behalf. Her welfare is based on her preferences and these preferences (and the manner of their formation) are not seriously disputed in a liberal society. This ontological view has been the target of attack by philosophers, sociologists, psychologists, even economists. However, if we accept the most elementary version of the premise of their critique we should conclude that, at least some times, in marginal cases, an individual might not be the best judge of her interests. Nonetheless, even then, it needs a big leap of faith to defend even the softest case of paternalism. Irrational or self-destructive preferences or actions do not justify paternalism in any case, under any circumstances. Nevertheless, one can easily understand the appeal of proposals for paternalistic policies that are particularly soft, even "libertarian" (Sunstein and Thaler 2003). The author of this chapter is very suspicious of any kind of paternalistic theory, even of those which are based on substantial scientific evidence[6] and promise to respect personal autonomy (Hatzis 2014a). On the other hand, we can't rule out a priori any form of soft paternalism, especially when this form is rigorously based on hypothetical consent and subjective well-being.

Moralism differs from paternalism in many respects – even though, quite often, the distinction is not so clear-cut (Hatzis 2009). According to moralistic theories, an act should be prohibited if it clearly violates morality. The strongest argument against "immoral" acts, liberties, and law is the one which defends conventional morality – the social morality shared by the majority of the population in a given society. This is the only kind of morality that one can persuasively argue that it should influence law. For conservative scholars, like James Fitzjames Stephen or Patrick Devlin, an act should be illegal if it grossly "offends" society's morals.

Stephen's arguments[7] are illustrative of this view:

> If society at large adopted fully Mr. Mill's theory of liberty, it would be easy to diminish very greatly the inconveniences in question. Strenuously preach and rigorously practise the doctrine that our neighbour's private character is nothing to us, and the number of unfavourable judgments formed, and therefore the number of inconveniences inflicted by them, can be reduced as much as we please, and the province of liberty can be enlarged in a corresponding ratio. Does any reasonable man wish for this? Could anyone desire gross licentiousness, monstrous extravagance, ridiculous vanity, or the like, to be unnoticed, or, being known, to inflict no inconveniences which can possibly be avoided? [...] How can the State or the public be competent to determine any question whatever if it is not competent to decide that gross vice is a bad thing? I do not think the State ought to stand bandying compliments with pimps. [...] My feeling is that if society gets its grip on the collar of such a fellow it should say to him, "You dirty rascal, it may be a question whether you should be suffered to remain in your native filth untouched, or whether my opinion about you should be printed by the lash on your bare back. That question will be determined without the smallest reference to your wishes or feelings; but as to the nature of my opinion about you, there can be no question at all." [...] Most people, I think, would feel that the latter form of address is at all events the more natural. [...] [T]he object of promoting virtue and preventing vice must be admitted to be both a good one and one sufficiently intelligible for legislative purposes. [...] It is one thing however to tolerate vice so long as it is inoffensive, and quite another to give it a legal right not only to exist, but to assert itself in the face of the world as an "experiment in living" as good as another, and entitled to the same protection from law.
>
> (Stephen 1993 [1873]: 11, 84–85, 96–97, 101)

In a similar vein, Lord Patrick Devlin emphasized the democratic element in his defense of the legal enforcement of morality. According to him, justice should be determined by the will of the majority; a consensus is necessary; if there is no fundamental agreement on good and evil a society will fail:

> For society is not something that is kept together physically; It is held by the invisible bonds of common thought. If the bonds were too far relaxed the members would drift apart. A common morality is part of the bondage. The bondage is part of the price of society; and mankind, which needs society, must pay its price. [...] But if society has the right to make a judgement and has it on the basis that a recognized morality is as necessary to society as, say, a recognized government, then society may use the law to preserve morality in the same way as it uses it to safeguard anything else that is essential to its existence. If therefore the first proposition is securely established with all its implications, society has a prima facie right to legislate against immorality as such.
>
> (Devlin 1977 [1965]: 74–75)

For Devlin, immoral acts are acts of treason since they are "harmful to the social fabric." According to him "[t]here are no theoretical limits to the power of the State to legislate against treason and sedition, and likewise I think there can be no theoretical limits to legislation against immorality" (Devlin 1977 [1965]: 77). Of course, Devlin didn't base his contentions on empirical observation but on the elusive concept of a "reasonable man": a representative of the moral majority in the sense that he is a right-minded man, holding commonly accepted views. Even Devlin uses this legal fiction with caution as he seems puzzled as to its ontological or even normative value.[8]

In both scholars we can discern at least two arguments (one explicit and another implicit) that are relevant to our discussion:

1 Social morality is shared by the majority of the population. In a democratic state this morality should be respected, especially if the disapproval is overwhelming. This is considered essential for a well-functioning society and polity (the explicit "democratic" argument).
2 The enforcement of widely accepted moral norms is imperative to the well-being of society. Not only because the non-enforcement could inconvenience the majority but because it could disintegrate society itself (the implicit "welfarist" argument).

One could adopt a less ominous argument that is also quite powerful: Acts that are considered immoral create negative externalities, "polluting" society morally and thus decreasing social welfare.

Moral externalities

The externality argument against "immoral" behavior which does not harm third parties directly (and against any "immoral" activity for that matter) goes something like this: a part of the cost of the voluntary but "immoral" activity spills over onto "moral" people, who are annoyed by the way of life of "immoral" people. Of course, every action and every transaction is likely to impose a cost on a third party. Even acts that are considered moral or amoral have negative external costs to third parties: An honest and active tax woman or a discount store will create negative externalities to small neighborhood businesses. However, the external cost is greater when this activity goes against conventional morality. Since individuals have preferences not only over their own choices but also about other individuals's actions, choices, and preferences, it is not surprising that the way of life or the acts of some people can be said to grossly offend the majority. Their acts or transactions have negative external effects of such magnitude that they can have detrimental effects to social order itself. Consequently, the argument goes, the state should intervene in order to protect the offended majority by making the "immoral" people internalize the cost of their "immorality", enhancing overall welfare.

According to the leading law and economics scholar Steven Shavell (2002: 255), "the existence of moral beliefs should itself influence the design of the law,

given that moral beliefs constitute tastes the satisfaction of which raises individuals' welfare." Richard Posner connects this argument with the prevalence of the democratic principle:

> Constitutional rights are, after all, rights against the democratic majority. But public opinion is not irrelevant to the task of deciding whether a constitutional right exists. [...] [Judges] will have to go beyond the technical legal materials, of decision and consider moral, political, empirical, prudential, and institutional issues, including the public acceptability of a decision recognizing the new right. [...] That is the democratic way [...] [not] to ignore what the people affected by the issues think about them.[9]
>
> (Posner 1997: 1595–1587)

One could argue that such a "negative externality" could even satisfy John Stuart Mill's harm principle: "[T]he sole end for which mankind are warranted, individually or collectively, in interfering with the liberty of action of any of their number, is self protection" (Mill 1859: I.9). According to a certain interpretation of Mill's thought,

> it is no objection under the harm principle that a harmless action was criminalized, nor even that an action with no tendency to cause harm was criminalized. It is enough to meet the demands of the harm principle that, if the action were not criminalized, that would be harmful.
>
> (Gardner and Shute 2000: 216)

Amartya Sen has contributed to this discussion indirectly with the "liberal paradox." According to Sen (1970, see also 1976), censorship, under certain conditions, can maximize welfare by restricting individual rights. If Sen is right, then:

> [L]iberal values conflict with the Pareto principle. If someone takes the Pareto principle seriously, as economists seem to do, then he has to face problems of consistency in cherishing liberal values, even very mild ones. Or, to look at it in another way, if someone does have certain liberal values, then he may have to eschew his adherence to Pareto optimality. While the Pareto criterion has been thought to be an expression of individual liberty, it appears that in choices involving more than two alternatives it can have consequences that are, in fact, deeply illiberal.
>
> (Sen 1970: 157)

Sen, of course, did not advocate any kind of legal moralism. However, his paradox is illustrative of the existing tension between utility (utilitarianism) and rights (liberalism). Nevertheless, there are ways out of the paradox. For example, rule utilitarianism is more responsive to rights than act utilitarianism. Below we will also see that Sen's paradox is based on a rather narrow conception of liberalism which is perfectionist and not procedural.

Political and legal philosophers, especially Joel Feinberg (1985; 1988), tried to set the conceptual boundaries of harm since there is literally no imaginable kind of behavior, transaction, or relationship which cannot be considered as harmful to some. One criterion could be the magnitude of harm (Feinberg speaks of "extreme offence") and another the number of people harmed, but then the road to legal moralism is a one-way street.[10] Mill himself has given a tough-minded answer, which seems to preclude any kind of legal moralism:

> There are many who consider as an injury to themselves any conduct which they have a distaste for, and resent it as an outrage to their feelings […]. But there is no parity between the feeling of a person for his own opinion and the feeling of another who is offended at his holding it; no more than between the desire of a thief to take a purse and the desire of the right owner to keep it.
>
> (Mill 1859: IV.12)

Economists seem to think that they do not have anything more to offer on this point. According to Trebilcock (whose discussion of moral externalities is very useful here), "[I]t is not clear to me that conventional economic theories of externalities have much, if anything, to offer on the problem" (Trebilcock 1993: 66 – referring to the negative externalities caused by pornography). Even in the simplest cases, Trebilcock feels that he should use concepts such as rights and autonomy (Trebilcock 1993: 75), which is fine but the point here is to find whether the concept of externalities itself can help by offering a clear-cut criterion, similar to that of Mill's or to Rawls's (1971: 13) mutual disinterest principle ("[people] are conceived as not taking an interest in one another's interests"). This is also important for the economic theory of externalities, since an uncontrolled expansion of the notion will make it trivial.

Richard Epstein's libertarian criterion is also very useful and it is compatible with the economic criterion I will be proposing:

> Seeking to respect all (but only) negative externalities by the legal system leads to a place where there is no decision for individual choice or personal self-control, a result that is wholly inconsistent with our ordinary intuitions about autonomy and self-control. So to avoid that situation we run to a world in which autonomy allows us to impose negative externalities on those with whom we refuse to deal but not on those upon whom we inflict force.
>
> (Epstein 1995: 700)

In his seminal article, Ronald Coase (1960) did not try to set boundaries for externalities since his main concern was to show that the problem is not externalities but transaction costs. According to David Friedman's reinstatement of the theorem:

> With externalities but no transaction costs there would be no problem, since the parties would always bargain to the efficient solution. When we observe

> externality problems (or other forms of market failure) in the real world, we should ask not merely where the problem comes from, but what the transaction costs are that prevent it from being bargained out of existence.
>
> (Friedman 2000: 40)

If it is a matter of bargaining in a low-transaction-cost environment one could identify the bargaining parties, their stakes, and, of course, a low-transaction-cost setting. With moral externalities this is more difficult than it sounds. The bargaining parties are apparently individuals and society, and as we will see, a low-cost environment can be identified. The problem is how to measure the willingness to pay when we deal with moral cost.

Scarce and non-scarce rights and the right to self-ownership

I believe that a distinction introduced by Meckling and Jensen (1980) in an unpublished paper and elaborated in another unpublished paper by Holderness *et al.* (2000) could be very useful for our analysis: External effects can be classified into physical and value effects. An example of the first is physical pollution of a neighbor's farm; an example of the second is the introduction of a product that reduces a competitor's profits. The first is a social cost, because options have been physically eliminated from someone else's opportunity set. The second is not a social cost (although the wealth of the competitor declines) because no options have been eliminated and no real resources have been consumed (Holderness 1989: 184, n9).[11] In the first case, it's a zero-sum game with distributive consequences. In the latter it is not.

In the second paper Holderness *et al.* (2000) discuss freedom of expression and connect the above distinction with the theory of rights by offering a criterion which is based on their treatment of externalities.[12]

To maximize freedom, one must differentiate between scarce and non-scarce rights. *Scarce rights* cannot be granted to everyone because of natural limitations caused by physical incompatibilities. When a scarce right is exercised, alternative actions that might have been taken are physically eliminated from the opportunity set, both for the person exercising the right and for all other individuals. When a scarce right is exercised, there is a cost because the right in this case is like a rival good: its use by one person diminishes or eliminates the use by another.

If one person burns a tree to keep warm, another cannot use the tree to build a house. Conflicts caused by such physical incompatibilities are resolved peacefully, by giving exclusionary rights in the physical use of the tree to a single, private party. These are scarce rights because more than one person cannot use the tree when there are physical incompatibilities.

Non-scarce rights, in contrast, can be granted to everyone. This class of rights is limitless, in the sense that granting a right to one person in no way precludes the opportunity to grant the same right to other people. The freedom to engage in an "immoral" non-harming activity does not forestall someone else from doing the same.

To maximize freedom, each scarce right must be assigned to specific individual persons, and all non-scarce rights should be assigned to everyone. Consequently, the right of self-ownership should be assigned to everyone individually and not only to the class of "moral" people – if they are the majority in a democratic society.

According to the self-ownership thesis "each person is the morally rightful owner of his own person and powers, and, *consequently*, that each is free (morally speaking) to use those powers as he wishes, provided that he does not deploy them aggressively against others" (Cohen 1995: 67).

Full ownership of an entity consists of a full set of the following ownership rights (Vallentyne 2014):

1 *control rights* over the use of the entity: both a liberty-right to use it and a claim-right that others not use it;
2 *rights to compensation* if someone uses the entity without one's permission;
3 *enforcement rights* (of prior restraint if someone is about to violate these rights);
4 *rights to transfer* these rights to others (by sale, rental, gift, or loan); and
5 *immunities to the non-consensual loss* of these rights.

According to this view of self-ownership, rights to transfer are as important as control rights. Thus we can see what Sen has missed. People can transfer their rights in order to maximize their utility. This transfer seems to limit their freedom but this is the essence of contract.[13] If we stick to an idea of inalienable rights that cannot be transferred even with the consent of their owners (and then self-ownership is a mirage) then every such transfer, if it happens, diminishes our liberty. This "perfectionist" version of liberalism (Raz 1986) is very problematic because it undermines self-determination and subjective well-being. According to a more neutral approach to liberalism (which I prefer to call "procedural liberalism"), if the process of transfer is based on genuine consent the result is fair and liberty-enhancing.[14] According to Brian Barry (discussing Sen's paradox): "Liberalism is, indeed, a principle that picks out a protected sphere, but one that is protected against unwanted interference, not against use in trading with others" (Barry 1986: 19).

A Coasean framework

One could then ask: Why should the value effects *not* be taken into account? Since society has a stake in the individual behavior (when this behavior has a social cost), why is there no right to interfere with another person's choices?

Using the wealth maximization criterion, can we imagine a world with no transaction costs where the majority of moral citizens would pay "immoral" people for the right of living the way they prefer? Putting it in a Coasean framework, if an "immoral" activity is legalized and there are no transaction costs, would it be possible for the legal entitlement to end up in the hands of the "moral

majority" with the consent of rights-holders? Of course it would, but the question remains: What is the value of the right for the "moral majority" and the "immoral minority"?

First of all, the specification of the utility function of the third moral party that is offended is important here. It all depends on the assumptions about what is entering the third party's utility. It seems that there is some kind of nonlinearity in the "moral" component of the utility function of the representative individual. The representative individual is willing to tolerate such behavior up to a point/threshold. What complicates things here is that the idiosyncratic component in the utility function from individual to individual is very high. So talking about an average utility function (or a function of the representative individual) is not very helpful.[15]

For these and other reasons, in most cases the value of a right is indeterminate. Since the benefits and the costs are highly subjective and mostly psychological, there is great difficulty in assessing them, even where there are no serious incidents of moral hazard, adverse selection, and endowment effects – which are all quite common in cases of idiosyncratic preferences. Posner's famous solution (mimic the market) coincides with the normative version of the Coase theorem (Posner 1983: 71–72). When transaction costs are high, the rights should be vested initially in those who are likely to value them most so as to minimize transaction costs. According to Posner's own example, "this is the economic reason for giving a woman the right to determine her sexual partners" (Posner 1983: 71). If this right is assigned to strangers, it will generally be repurchased by the woman. However, the costs of the rectifying transaction should be avoided, thus the right should be assigned to the user who values it the most. In addition, since there is no reliable mechanism for identifying this *ex ante*, and thus vesting the right in the persons who value them most, the rights should initially be vested "in the natural owner" (Posner 1983: 72).

Another useful criterion could be Guido Calabresi's "best briber" solution to the normative Coase theorem, according to which the allocation of rights should be made in such a way "as to maximize the likelihood that errors in allocation will be corrected in the market" (Calabresi 1970: 150). In our case this comes to the following strategy: assign the right to the party from whom it could be transferred more easily. In all the self-ownership cases (organ-selling, surrogate motherhood, euthanasia) the interested parties are always a small minority (the "natural owners"). Their sheer number qualifies them since the right can be more easily moved from a small concentrated minority rather than from the dispersed and heterogeneous majority. However, as we will see in the next paragraph, there is an even stronger argument. Calabresi himself answers indirectly, since he discusses the reduction of primary costs in accidents: "The best briber may therefore be the activity that can enter into transactions with the least use of coercion" (Calabresi 1970: 151).

Minimizing transaction costs by recognizing individual rights

However, the most important problem is the amount of transaction costs involved if we assign the right to self-ownership not to the persons themselves, but to society at large. This is clearly illustrated by Clifford Holderness's treatment of positive externalities that are created by a contract. How can we distinguish between positive externalities and third-party beneficiary rights created by a contract? In my opinion, Holderness (1985) has provided the most satisfactory answer to the problem, discussing the issue of positive externalities from a contractual relationship. For Holderness, a necessary foundation for exchange is that the law assigns all rights to any resource to a closed class of clearly identifiable persons, each of whom is able to contract at any moment. A class is closed when persons can enter the class – and thus obtain the right – only by first purchasing the right from a current class member (Holderness 1985: 322). The rights, therefore, must lend themselves to voluntary transfer and this is not possible when the rights are assigned to open classes. If they are, then no voluntary transactions can take place and resources are blocked from moving to higher-valued uses.

Paraphrasing Holderness (1985: 324), we could say that an open class in negative externalities (value external effects) is created when there are at least some individuals who can enter the class, and thus obtain rights, without first purchasing them from the natural owners. "A class is open when entry to it is unrestricted" (Holderness 1989: 182).

If we give rights of moral protection to too many individuals (the whole society) by recognizing as harm the violation of conventional morality, the transaction costs for any hypothetical exchange will exceed the expected gains even if the rights are alienable. The larger the class of rights-holders, "the greater will be the transaction cost of arranging an exchange," because the prospective "immoral" person must negotiate with each individual who has been assigned rights to the life of third parties (cf. Holderness 1985: 326). This essentially means that a person can make decisions about his life only when he can identify all individuals who have been assigned rights to his life. One could argue that in a democracy this is not necessary: it is enough to persuade the majority. However, if the history of individual rights is an indication, the transaction cost is enormous in terms of time but most important in terms of human lives.

When the individual is unable to identify the other individuals who have been assigned rights to his life, "this calculation becomes impossible to make independent of the court." Accordingly, he is then put in the predicament of either not doing what he wants to do with his life or doing it and then subjecting himself to the court *ex post* rule (Holderness 1985: 327). The solution to the problem is to deny rights to an "indeterminate class" (Holderness 1985: 333) with unrestricted entry. Since these rights will be essentially inalienable, exchange would be futile. As Ronald Coase famously put it, "the delimitation of rights is an essential prelude to market transactions" (Coase 1960: 8).

This is also one of the problems of Sen's "liberal paradox." According to James Coleman, Sen's paradox "indicates the central position of externalities – either external diseconomies or external economies – in a theory of constitutions, for it is only in the presence of externalities that the most critical issues arise, those which distinguish different philosophical positions" (Coleman 1990: 341).

Conclusion

My goal in this chapter was twofold. One of my objectives was to try to rebut an economic argument for legal moralism by using another economic argument. My second objective was to show how law and economics literature can be fruitfully used in the discussion of issues that are considered *prima facie* irrelevant to the economic approach.[16] As we have seen, the theory of externalities can support the view that conventional morality should not be irrelevant for legislation if the increase of the welfare of society is one of law's legitimate goals. However, I also tried to demonstrate how the assignment of rights to the "moral majority" under the assumption that this would maximize total welfare undermines the Coasean dynamics because of the creation of open classes of right holders. The external effects that "immorality" can create are value effects, not physical effects. The right to an "immoral behavior" in particular is not a scarce right. Thus, exercising this right does not preclude anyone else from doing the same.

My conclusion is not a system of moral anarchy, but an appeal to the importance of "establishing closed and identified classes of rights holders" (Holderness 1985: 344). This can be achieved by assigning the right to self-ownership to individuals themselves, instead of making society, i.e., the "moral majority," a co-owner.[17]

Notes

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1 See (Gauthier 1986: 84).

2 For the rich literature in legal and moral philosophy see (Alexander 2003; Bix 2006: 157–166).

3 We are not going to discuss here more sophisticated views on moral intuitionism, moral realism, foundationalism, etc. In this text we are only going to discuss conventional (not critical) morality and the arguments for and against its influence on legal rules. Nevertheless, the author of this chapter feels obligated to stress that he does not subscribe to theories of moral subjectivism or moral nihilism.

4 See, e.g., (Kass 2002). Even the concept of autonomy can be used in a way that is paternalistic (see the survey by Fateh-Moghadam and Gutmann 2014).

5 I consider a liberal anarchist society as no realistic option. See (Nozick 1974) for more. See also (Friedman 1989) for an alternative view.

6 Mostly from psychology under the rubric of behavioral economics. However, see (Foka-Kavalieraki and Hatzis 2011).
7 Stephen's book is essentially a conservative rebuttal of Mill's *On Liberty*.
8 For a famous rebuttal see (Hart 1963).
9 See also (Posner 2003): "in a democratic society, powerful currents of public opinion deserve recognition even by the Supreme Court, at least in cases to which neither the Constitution nor any other authoritative legal text speaks with clarity." See, however, more recently (Posner 2013).
10 On this issue, see (Dworkin 1978: 255). According to Dworkin, "what is shocking and wrong is not his [Devlin's] idea that the community's morality counts, but his idea of what counts as the community's morality." I find this distinction to be far from satisfactory.
11 This is essentially the distinction between externalities and pecuniary externalities, which is much older (cf. Posner 1983: 96).
12 The following paragraphs draw heavily from (Holderness *et al.* 2000).
13

> In a market exchange that leads to a contract, two (or more) rational actors promise to limit their future actions with the objective of deriving, from the present or future actions of the other party, a benefit that will be greater than the cost of restricting their actions.
>
> (Foka-Kavalieraki and Hatzis 2009: 30)

14 This approach is not identical but it is not very far from Nozick's "justice in transfer."
15 I owe this point to George Chortareas.
16 See also (Donohue and Levitt 2001; Hatzis 2003; 2006; 2009; Karayiannis and Hatzis 2012).
17 Individuals should be free to trade their rights if they so wish. One way to do this might be a system of moral federalism, a system where individuals choose their residence and vote over a single-dimensional regulatory policy at the regional and national level (Janeba 2006).

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