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Introduction to *Fairness in Law and Economics* (Edward Elgar, 2013)

Lee Anne Fennell & Richard H. McAdams*

The relationship between fairness and the economic concept of efficiency is usually cast as an adversarial one.¹ Rational choice economics describes human behavior as motivated by simple self-interest, rather than by concerns of morality, justice, or fairness. Thus, it may seem strange to devote a volume to fairness within the field of law and economics. Yet we have found that the connections between concepts of fairness and the economic analysis of law are robust and diverse. We have compiled a volume of scholarship in which economics engages with fairness, challenging the idea that the two concepts are alien to each other. Indeed, the literature is so large that we could easily have produced a volume several times the size of this one.

We begin this introduction with some observations on the importance—indeed, inescapability—of fairness concerns in law and economics. We then discuss the organization and content of this volume.

THE INEVITABILITY OF FAIRNESS CONCERNS IN LAW AND ECONOMICS

Whatever one may think of fairness as an independent normative criterion, a law and economics researcher cannot avoid confronting fairness concerns. As a positive matter, there is the brute fact of fairness preferences. A wealth of experimental data corroborates the everyday observation that people care about, and respond to, fair and unfair treatment. Individuals exhibit both an aversion to arbitrary inequality and a preference for inequality based on desert. Predictions about human behavior will go badly astray if they fail to recognize when individuals will, at a cost to themselves, choose to distribute wealth to others, reward those who contribute to public goods, or punish those who free-ride. The most parsimonious theory for many disparate experimental and real world observations across many cultures is that people get utility from reciprocating kindness with kindness and unkindness with unkindness. Quite simply, people gain and lose when they observe or help to create fair and unfair states of affairs. As the literature we review shows, fairness preferences affect fundamentals such as market prices, bargaining, and compliance with law. One ignores them at great explanatory cost.

Fairness turns up in normative theory as well, appearing both as an input into, and a rival criterion to, welfare economics. Welfare theory can incorporate a preference for fairness in two ways. First, the satisfaction of fairness preferences generates welfare just as the satisfaction of any preference generates welfare. Second, fairness is often concerned with distribution, and a social welfare function (SWF) can be structured to value certain distributions. A utilitarian SWF seeks to maximize the sum of individual

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¹ This view is encapsulated in works like ARTHUR OKUN, *EQUITY AND EFFICIENCY: THE BIG TRADEOFF* (Washington DC: Brookings Institution Press, 1975).

utilities, but welfare theory is also consistent with the selection of a SWF that would put some independent weight on achieving equality of welfare across individuals.²

In another sense, however, fairness and welfare really are rivals. Kaplow and Shavell (K&S) have famously argued that fairness (which they take to include any non-welfare value, such as morality, justice, or dignity) has no value apart from its effect on welfare.³ Moreover, to the extent that distribution of resources affects welfare, K&S contend that the law should pursue its distributive objectives entirely through taxes and transfers.⁴ Together, these two theses suggest there is no reason for non-tax law to concern itself with fairness because (a) the correct goal is welfare and (b) to the extent that the fairness of material distribution affects welfare, the only correct policy response is an adjustment in taxes. Economists have criticized both K&S theses, and we reproduce some of those debates here.⁵ Our review of the literature has inspired some additional thoughts about the normative relevance of fairness to the economic analysis of law. We will mention four.

First, law and economics scholarship tends to artificially separate questions of efficiency (“the size of the pie”) from questions of fairness or distribution (“who gets which slices”).⁶ But maximizing and slicing are not separate operations if our ultimate concern is welfare rather than wealth. One can separately create and redistribute wealth, but one cannot “take” someone’s welfare and dole it out to others. Some of the ways in

² For example, a SWF might incorporate a Rawlsian theory of distributive justice that allows inequality only when necessary to improve the lot of the least well off. More weakly, Matthew Adler’s continuous prioritarianism gives additional weight to the welfare of the least well off, but does not rule out all increases in inequality that fail to leave them better off. See MATTHEW D. ADLER, *WELL-BEING AND FAIR DISTRIBUTION: BEYOND COST-BENEFIT ANALYSIS* 356-378 (New York NY: Oxford University Press, 2011).

³ See Louis Kaplow & Steven Shavell, *The Conflict between Notions of Fairness and the Pareto Principle* (this volume) and Louis Kaplow & Steven Shavell, *Any Non-welfarist Method of Policy Assessment Violates the Pareto Principle* (this volume); see also LOUIS KAPLOW & STEVEN SHAVELL, *FAIRNESS VERSUS WELFARE* (Cambridge MA: Harvard University Press, 2002).

⁴ See Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income* (this volume) and Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income* (this volume).

⁵ We stress that our coverage is far from comprehensive. We have included work by only a fraction of the scholars who have made valuable contributions to these debates, and we have also had to truncate some debates that continued beyond the articles reproduced here.

⁶ See, e.g., A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 7 (New York NY: Wolters Kluwer Law & Business, 4th ed. 2011) (“efficiency corresponds to ‘the size of the pie,’ while equity has to do with how it is sliced”). This division of labor is evident in the approaches that welfarists like K&S employ, and can also be observed in the two Fundamental Theorems of Welfare Economics. See, e.g., ANDREU MAS-COLELL, MICHAEL D. WHINSTON & JERRY R. GREEN, *MICROECONOMIC THEORY* 326-27 (New York NY: Oxford University Press, 1995) (stating the First Theorem, in which a competitive equilibrium yields a Pareto optimal allocation, and the Second Theorem, in which transfers of a numeraire commodity can produce, through a competitive equilibrium, any given Pareto optimal set of utilities); Edward J. McCaffery, *A New Understanding of Tax*, 103 MICH. L. REV. 807, 817 n.21 (2005) (referencing “the argument of Louis Kaplow and Steven Shavell, tracking the two welfare theorems, that the general legal system should be evaluated vis-à-vis the goal of welfare maximization or allocative efficiency, leaving the tax system to redistribute wealth.”); Michael J. Meurer, *Fair Division* (book review), 47 BUFFALO L. REV. 937, 941 n. 28 (1999) (“Law and economics scholars rely on the Second Theorem to justify legal analysis that bifurcates efficiency and fairness analysis of the law. The usual attitude is that law should be shaped by efficiency concerns, and the legislature can achieve fairness through taxing and spending policies.”).

which society advances welfare involve the in-kind distribution of entitlements like civil rights and civil liberties that cannot later be distilled into transfer payments if they are initially allocated unfairly.⁷ Further, the perceived fairness of societal rules and institutions can increase or decrease welfare in ways that cannot be replicated through the redistribution of money. For example, if governmental exercises of eminent domain are viewed as unfairly taking property away from private parties, even direct compensation to those parties will not necessarily address the disutility that they (and onlookers) feel; tax credits that merely elevate the financial position of people in the condemnee's income bracket would be even less responsive to the utility loss. Because fairness preferences influence welfare directly and nontransferably, we cannot divide the tasks of creating welfare and distributing it.

Second, even if wealth maximization is accepted as a useful way station on the path to achieving society's preferred social welfare function, fair distribution—and fair processes of distribution—may be a necessary step toward maximizing wealth. Fairness perceptions and the consequences of perceived unfairness can profoundly influence all of the activities and choices that would otherwise make the pie grow, from cooperating, to bargaining, to settling disputes, to complying with the law. For example, we should expect more crime, and particularly more theft, if there is unequal distribution of wealth, so a “fair” distribution might be necessary to reduce crime and thereby maximize wealth. If we want to motivate the population to obey law and contribute to public goods, as a means of maximizing wealth, it may be necessary that they perceive the legal system as being fair in ways that depend on the substantive content of legal rules and not only the structure of tax law.⁸ If we wait until pie-slicing time to make things fair, we might find ourselves slicing a smaller pie.

Third, fairness considerations bear on *which* social welfare function to use. In their examples, K&S often use a utilitarian SWF, but they insist that their defense of welfare is consistent with other SWFs, including those that put value on the equal distribution of welfare (as by maximizing the product of individual utilities rather than maximizing their sum). As a purely definitional matter, K&S would not view the choice of an SWF as implicating fairness, because they define the term “fairness” to refer exclusively to nonwelfarist concerns. Yet because the choice of a particular SWF necessarily involves a decision about how to weigh the distribution of welfare (the decision to ignore distribution being a distributive choice), the welfarist endeavor cannot be entirely separated from what many view as core questions of fairness.

Indeed, as Daniel Farber explains, there is nothing in K&S's account that would counsel against a person or society reasoning backwards from a fairness intuition to decide which SWF to pick.⁹ A theorist who believes people should not be free to sell themselves into slavery can, without violating any principle of welfare theory, ask which SWFs are maximized by allowing such an institution and reject them for that reason. Instead of welfarism absorbing preferences for fairness, preferences for fairness dictate

⁷ For a related discussion, see Daphna Lewinsohn-Zamir, *Can't Buy Me Love: Monetary versus In-Kind Remedies*, 2013 U. ILL. L. REV. 151.

⁸ For example, people are more likely to comply with criminal law if they perceive their local police to be procedurally fair. See, in this volume, Tom Tyler, *Procedural Fairness and Compliance with the Law*.

⁹ Daniel A. Farber, *What (If Anything) Can Economics Say About Equity?*, 101 MICH. L. REV. 1791, 1802-3 (2003).

which form of welfarism we choose. The very act of constructing a social welfare function requires answering a host of questions that require a fairness theory, beginning with the question of whose welfare should count. The intuitions that tell us to include infants and people with disabilities, and to exclude some animals and all plants are not welfare theories, but instead fall within the category of moral theories that K&S associate with fairness. In the end, one aggregates the welfare it is fair to aggregate.

Finally, and most interestingly, the welfarist's ideal point can be reached by more than one potential path, and there are fairness-based reasons to suspect that the K&S-endorsed combination of efficient legal rules and tax and transfer will not always be the cheapest route. The reason relates to the political costs of redistribution, and it requires a bit of groundwork to set up.

Suppose that we adopt a SWF that calls for maximizing the sum of individual welfare levels.¹⁰ We cannot maximize welfare without paying attention to the distribution of wealth, unless one believes (improbably) that maximizing wealth will also automatically maximize welfare.¹¹ Maximizing welfare thus requires achieving certain distributive objectives. On K&S's account, those objectives should be pursued exclusively through tax and transfer mechanisms. Their reason for preferring such mechanisms over legal rules that aim in the direction of the welfare-maximizing distribution is based on the behavioral distortions that each approach might be expected to generate. If we (for example) grant larger recoveries to impecunious tort victims than to wealthy ones, or charge rich injurers more than we charge their less well-off counterparts, the argument runs, we will distort not only their labor-leisure choices but will also introduce a distortion in their tort-related conduct.¹² The latter distortion occurs because the tort rule selected for distributional reasons will deviate from the tort rule that is optimal for maximizing wealth. Assuming the labor-leisure distortion is equivalent for both methods of redistribution,¹³ we should favor the method that does not entail an additional distortion.

¹⁰ Our analysis would be the same if some other SWF were selected, as long it was sensitive in some way to the distribution of wealth. We choose the utilitarian criterion here for simplicity and concreteness.

¹¹ The intuitive reason why maximizing wealth will be unlikely to maximize welfare relates to the diminishing marginal utility of money. The marginal dollar held by the well off is likely to do a very poor job at producing increases in welfare, compared with the marginal dollar held by the less well off. Put another way, wealth maximization focuses on maximizing value as measured by willingness to pay. But given unequal wealth distributions, willingness to pay is a poor metric for the utility that will be derived from a given resource. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 15-16 (New York, NY: Aspen Publishers, 8th ed. 2011) (presenting an example in which a poor family has a much greater objective need for pituitary extract than does a rich family, and observing that “[i]n the sense of value used in this book, the pituitary extract is more valuable to the rich family than to the poor one, because value is measured by willingness to pay”); Herbert Hovenkamp, *Positivism in Law and Economics*, 78 CALIF. L. REV. 815, 840 (1990) (discussing how wealth differentials can introduce discrepancies between who is willing to pay the most for something and who will derive the most utility from it).

¹² See this volume: Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income* and Louis Kaplow & Steven Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*.

¹³ Redistribution creates a distortion in the work/leisure trade-off because the individual receives 100% of the value of his or her leisure, but less than 100% of the value of his or her work. This distortion occurs whether one is redistributing through taxes or the substantive content of legal rules (other than tax). But see Christine Jolls, *Behavioral Economics Analysis of Redistributive Legal Rules*, this volume (questioning

Yet efforts to achieve distributive objectives carry political costs in addition to those K&S discuss.¹⁴ Any proposed distributive change, whether accomplished through legal rules or through tax policy, elicits a certain amount of political resistance. This resistance may impede movement to a preferred distributive position, or cause great welfare losses in the process of achieving such movement. Fairness preferences may themselves raise these political costs because people have different conceptions of fairness and are willing to incur costs to bring them about. Thus, the wealthy may lobby to reduce tax burdens below the optimal level, while the middle and lower income groups may push for a higher than optimal level of progressivity.¹⁵ Crucially, the size of political costs may vary by the method of redistribution. Achieving a unit of redistribution through substantive legal rules may not carry the same political costs as achieving that redistribution unit through taxes and transfers. If people are more willing to incur political costs when they perceive distributive changes as unfair (or indeed, when they perceive them *as changes*), then the manner in which distributive goals are pursued matters.

Put differently, the choice is not between one labor-leisure distortion through tax rules or that same distortion to labor-leisure *plus* a second distortion in other behavior through non-tax rules. Instead, if we are listing the costs of the two methods of redistribution (tax vs. doctrine), we have (by assumption) an invariant cost on both sides of the ledger (the labor-leisure distortion), an additional cost on the doctrinal side of the ledger (the behavioral distortion), *plus* the political costs of redistribution, which also fall on both sides of the ledger. But there is no reason to expect that the magnitude of the political costs will be invariant to the means of redistribution. Because the political costs of tax redistribution could be much higher than the political costs of doctrinal distribution—enough higher to outweigh the behavioral distortion uniquely associated with legal rules—it is an empirical question which is the cheapest method.

It should not be surprising or controversial that moving resources among people costs something, and that these costs should matter to an economic analysis; indeed, this is the core message of the Coase Theorem.¹⁶ If transaction costs were actually zero, one would achieve efficiency regardless of the legal rules because the parties would always bargain to the efficient outcome. But while legal doctrine would not affect efficiency, it would still affect distribution, because the legal rule determines who (if anyone) has to pay whom to move the entitlement to the highest valued user. Thus, with zero transaction costs, the only remaining reason to pick one substantive legal doctrine over another would be distributional (fairness) considerations.¹⁷ Of course, transaction costs are not

whether the labor/leisure distortion is as large when redistribution is accomplished through legal rules as it is when accomplished through tax and transfer, given cognitive biases).

¹⁴ We are not the first to note the potential implications of political costs for the K&S thesis. *See, e.g.,* Richard S. Markovits, *Why Kaplow and Shavell's "Double-Distortion Argument" Articles Are Wrong*, 13 GEO. MASON L. REV. 511, 557, 597-601 (2005).

¹⁵ The influence of self-interest on perceptions of fairness is explored in Linda Babcock, George Loewenstein, Samuel Issacharoff, and Colin Camerer's article in this volume, *Biased Judgments of Fairness in Bargaining*. Thus, even citizens who strive to pursue fairness in distributive results may tend to pursue results that favor their own interests. For one take on how class coalitions might play out in the political arena, see George J. Stigler, *Director's Law of Public Income Redistribution*, 13 J. L. & ECON 1 (1970).

¹⁶ *See* R.H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960).

¹⁷ Stewart Schwab has dubbed this point "the distributive corollary of the Coase Theorem." Stewart Schwab, *Coase Defends Coase: Why Lawyers Listen and Economists Do Not*, 87 MICH. L. REV. 1171, 1195

zero, but once we start to consider the costs of moving resources among people to achieve welfarist objectives, we must count *all* the costs, including political ones. Because our goal is to find the least costly way to achieve the welfare-maximizing distribution—whether through tax rules, substantive legal rules, or a combination of the two—we must take into account the political costs that the K&S thesis ignores.¹⁸

Some examples will help to clarify our point. One basic decision is whether a resource will be distributed through markets or through non-market criteria. Suppose there are some goods—kidneys for transplant, subsistence-level food, freedom from military service or jury duty—for which many people do not think that willingness to pay represents a normatively fair metric. If legal institutions follow fairness intuitions in allocating that resource instead of auctioning it to the highest bidder, what is lost and what is gained? Following K&S, it might seem we lose efficiency by distorting decisions in the relevant market, and we gain nothing because whatever distributive changes are generated by our allocation mechanism can be more cheaply produced through tax and transfer. Both parts of this equation require scrutiny.

Recall that our ultimate objective is (by assumption) not wealth maximization but welfare maximization. Some notions of fairness implicitly or explicitly incorporate the observation that resources may generate more well-being in the hands of those who cannot bid the largest number of dollars for them.¹⁹ If these fairness intuitions do a relatively good job on average of tracking the real variable of interest—utility or welfare—they may offer a better guide to efficiency (defined by reference to such a maximand) than does willingness-to-pay, at least in some contexts. For example, where wealth differentials are great, a rule that allocates a particular good – for example, a minimal allocation of food or a kidney transplant – based on expert assessment of need might do better than an auction if other indicia of the good's utility to the potential recipients – like post-transplant longevity – are available.²⁰ In some cases, such as the allocation of certain governmental benefits or services, the willingness to incur the costs of a queue might be a better proxy for welfare than a willingness to pay.²¹

(1989) ("With zero transaction costs, initial entitlements cannot be justified on efficiency grounds, and so should be awarded on the basis of need or desert."); *see also* Meurer, *supra* note 6, at 943 ("[W]hen Coasean conditions of low transaction costs prevail, then property rights should be allocated according to fairness criteria[.]"); James E. Krier & Stewart J. Schwab, *Property Rules and Liability Rules: The Cathedral in Another Light*, 70 NYU L. REV. 440, 448 (1995) ("In short, when transaction costs are insignificant, efficiency concerns become irrelevant to the judge's inquiry; only justice reasons matter.").

¹⁸ K&S do recognize that there may be political impediments to optimal redistributive taxation, but do not address the point's implications for their thesis in depth. *See, e.g.*, Kaplow & Shavell, *Why the Legal System is Less Efficient than the Income Tax in Redistributing Income*, this volume, at 675 ("An argument sometimes offered in favor of redistribution through legal rules is that the tax system falls short of optimal redistributive taxation—perhaps because of the balance of political power in the legislature. This argument raises questions that we do not seek to address about the function of courts in a democracy."); *see also* Markovits, *supra* note 144, at 597-601 (discussing K&S's treatment of political barriers).

¹⁹ Sen's capability approach, discussed in his contribution to this collection, provides one example. *See* Amartya Sen, *On the Foundations of Welfare Economics: Utility, Capability, and Practical Reason*, this volume.

²⁰ We focus here only on the method of allocating of kidneys to end users. Using a need-based allocation criterion would be fully consistent with the use of market mechanisms to purchase kidneys from sellers.

²¹ For a related discussion, see generally Ronen Perry & Tal Z. Zarsky, *Queues in Law* (working paper, 2012) available at <http://ssrn.com/abstract=2147333>.

Not only might using such fairness criteria to select legal rules offer a more direct route to society's welfare maximizing point, we might expect the correspondence of these criteria to fairness intuitions to ease the political path. Moving a certain number of dollars from one income class to another might generate less political resistance when done by a substantive (non-tax) legal rule that is popularly perceived as fair than by a tax-and-transfer system that is widely viewed as unfair. The public might perceive in the latter case but not the former that we are taking away money from people who have "earned it," and giving it to others who have not.²² If common attitudes about deservingness or desert apply differently for substantive legal rules than for the tax system, then the political costs of redistribution through these mechanisms will be asymmetric as well. Notably, the affront to fairness associated with the shift, and the political costs it generates, exist independent of the effects on the labor/leisure choice. Even if we assume that allocating certain goods outside of the market structure distorts the labor/leisure choice just as much, due to its effects on the value that one can derive from one's earnings, the political opposition may be substantially less. Significantly, this point holds whether one believes that political opposition is more likely to hamper moves toward greater progressivity, or moves in the opposite direction.

To take another example, consider siting decisions for locally undesirable land uses. It may be inevitable that less wealthy people will end up next to these sites in the long run, whether because their communities are targeted initially, or because they move near the areas following the depreciation of the surrounding land and the evacuation of wealthier landowners.²³ But this very inevitability suggests a bargaining opportunity that could vindicate distributive objectives. Entitlements could be granted in a way that would require the well-off to make payments to the less well-off in order to produce or maintain this spatial pattern.²⁴ This combination of initial allocation and later bargaining might be cheaper—to the extent it better accords with notions of fairness—than a similarly-sized transfer payment to the less well-off.²⁵ Thus, a focus on political costs suggests that fairness comes into the analysis not only in defining the distributive goal, but also in determining how it may be most cost-effectively pursued.

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²² See LIAM MURPHY & THOMAS NAGEL, *THE MYTH OF OWNERSHIP: TAXES AND JUSTICE* 35 (New York NY: Oxford University Press, 2002) ("If people intuitively feel that they are in an absolute sense morally entitled to their net incomes, it is not surprising that politicians can get away with describing tax increases (which diminish net income) as taking from the people what belongs to them.").

²³ See Vicki Been, *What's Fairness Got to Do With It? Environmental Justice and the Siting of Locally Undesirable Land Uses*, 78 CORNELL L. REV. 1001, 1018-24 (1993) (discussing and critiquing the "mobility objection" to fair siting policies, which "asks whether siting decisions will have any enduring distributional effect, given the dynamics of the housing and land markets").

²⁴ The discussion in the text assumes that some households will be located near the locally undesirable land use, so that the question is one of distributing the costs associated with the siting. It is of course possible that the appropriate policy response would involve separating the land use from residential areas altogether.

²⁵ That the route to a result may matter is consistent with the work of Bruno Frey and his coauthors in their piece in this volume, *Introducing Procedural Utility: Not Only What, but Also How Matters*. See also Daphna Lewinsohn-Zamir, *In Defense of Redistribution through Private Law*, 91 MINN. L. REV. 326, 357-60 (2006) (arguing that the goodness or badness of a particular gain or loss depends not only on its size but also on the process by which it came about).

Our goal in this volume is to offer readers entry points into the body of scholarship exploring the connections between fairness and the economic analysis of law. In the course of constructing the collection, we discovered that these connections are expansive and diverse. Distilling the literature into a useful volume of reasonable length required us to make a number of difficult decisions about inclusion and exclusion, which we explain here.

The volume is divided into three parts. Part I engages in positive analysis. The articles in this section investigate fairness perceptions and preferences from empirical and theoretical perspectives, and examine the impact of these perceptions and preferences on legal outcomes and the effectiveness of legal rules. Part II turns to normative analysis and to the broad question of how law should reconcile fairness and efficiency considerations. Much of this part is organized around two debates sparked by Louis Kaplow and Steven Shavell, one on whether fairness should play any independent role in normative analysis, and another on whether legal rules should be used to realize distributive goals. Part III presents a series of applications. The pieces in this section take up fairness in law and economics within a variety of policy areas and doctrinal contexts.

We begin the positive analysis with articles discussing fairness preferences and, to a lesser extent, fairness beliefs, each of which constitutes a fundamental means by which fairness matters for economic models. A good starting point for the volume is Matthew Rabin's pioneering article *Incorporating Fairness into Game Theory and Economics*. Rabin posits that individuals react emotionally to the perceived intentions of others, i.e., the intent to help or hurt, and that those emotions change the utility payoffs of different actions, creating new "fairness" equilibria in many games. The preference for fairness can therefore change behavior, but even when behavior is unchanged, the preferences can have welfare effects (of the sort mostly discussed in Part II). Rabin describes the experimental data supporting fairness preferences in 1993, but there has been a lot of work since that time, as subsequent articles show. A good example is *In Search of Homo Economicus: Behavioral Experiments in 15 Small-Scale Societies*, in which Joseph Henrich and co-authors show that the experimental support for fairness preferences are, to some degree, transcultural. They ran ultimatum, public goods, and dictator game experiments on non-student populations in diverse non-industrialized societies and their results show that preferences other than conventional self-interest are at play, though there are interesting differences between cultures they seek to explain. Another recent example is Pamela Jakiela's *Social Preferences and Fairness Norms as Informal Institutions: Experimental Evidence*, which shows how behavior in Dictator Games is affected by whether the money being divided was obtained by luck or earned by effort. She finds evidence that people have fairness preferences based on "deservingness," but that these preferences vary across cultures.

Armin Falk & Urs Fischbacher seek to explain the more recent wealth of experimental data from these and other games in their article *A Theory of Reciprocity*. The authors present a formal model of reciprocity, extending Rabin's article to account for behavioral responses to the interpersonal comparison of outcomes, as well as to the evaluation of intentions. Reciprocity is, of course, well within the ambit of fairness, as reciprocating "kindness" and "unkindness" (broadly understood in these articles) is part

of what individuals commonly characterize as fair behavior. Falk & Fischbacher also explain how individuals trade off their preference for reciprocity for other goods, so that in competitive markets, even those who value reciprocity can agree to very unfair contracts. In a later article, *Testing Theories of Fairness—Intentions Matter*, Falk, Ernst Fehr, and Fischbacher identify the difficulties of proving from then-existing data whether people's behavior responds to their perception of the intentions of others. They design and present an experiment to overcome these difficulties, finding that behavior is explained by neither material distribution nor intentions *alone*, but by models considering *both* distribution and intentions.

Much of the fairness literature emphasizes the reciprocation of kindness, but there is a subliterate that focuses on preferences for punishing negative behavior. People are willing to pay to punish individuals who have transgressed in experimental games, such as free-riders who fail to contribute in a public goods game, even though the experimental design rules out any strategic incentive for punishment. Jeffrey P. Carpenter summarizes this literature and extends it in *The Demand for Punishment*. He presents experimental results showing that punishment behavior follows the law of demand, in that people punish less as the price of punishment rises.

Following this overview of fairness preferences, we turn briefly to fairness beliefs. In *Fairness and Redistribution*, Alberto Alesina & George-Marios Angeletos offer a positive political model of tax and welfare policies. Their model shows that there can be multiple equilibria where such policies are supported by different equilibrium fairness beliefs about the connection between work effort and wealth. For example, there can be a European-style equilibrium with high levels of tax progressivity and social insurance, weaker work effort, and fairness beliefs that emphasize the connection between luck and wealth. Yet there can also be an American-style equilibrium with low progressivity and insurance, high work effort, and fairness beliefs that emphasize the connection between effort and wealth.

Next, we turn to the legal and economic consequences of fairness perceptions and preferences. Three articles explore the impact of fairness considerations and beliefs on prices, bargaining, and settlement. Daniel Kahneman, Jack L. Knetsch, and Richard Thaler's canonical piece *Fairness as a Constraint on Profit-Seeking: Entitlements in the Market* uses an experimental design to study how the perceived unfairness of actions like sharply raising the price of snow shovels during a snow storm might cause firm behavior to diverge from economic predictions. Linda Babcock, George Loewenstein, Samuel Issacharoff, and Colin Camerer's article *Biased Judgments of Fairness in Bargaining* experimentally examines how systematically self-serving perceptions of fairness influence predictions of judicial outcomes and contribute to bargaining impasse. In *Pretrial Settlement with Fairness*, Amy Farmer and Paul Pecorino theoretically model the impact of fairness perceptions and tastes on pre-trial bargaining dynamics.

The next set of articles explores the implications of fairness perceptions for law enforcement and legal compliance. Tom R. Tyler's pathbreaking work *Procedural Fairness and Compliance with the Law* underscores the importance of processes that are believed to be fair in producing the legitimacy that supports widespread voluntary compliance with the law. In *Introducing Procedural Utility: Not Only What, but Also How Matters*, Bruno S. Frey, Matthias Benz, and Alois Stutzer try to incorporate into economics the idea that individuals care not only about outcomes, but also the procedures

that produce outcomes. They explore how procedural utility affects behavior, including compliance with law. One promising area of application for these ideas is tax compliance. We include a recent selection from the growing literature on this topic: Marius van Dijke and Peter Verboon, *Trust in Authorities as a Boundary Condition to Procedural Fairness Effects on Tax Compliance*. Finally, Richard McAdams examines additional facets of the question of legal compliance in *Economic Costs of Inequality*, including the possibility that material inequality increases street crime and political corruption, as it increases their productivity relative to legal options for generating income.

Part II turns to normative analysis, beginning with some pieces that, in various ways, frame the relationship between efficiency and fairness. In *On the Foundations of Welfare Economics: Utility, Capability, and Practical Reason*, Amartya Sen shows how a capabilities approach offers an alternative to utilitarianism as a foundation for welfare economics—one that can do a better job of avoiding unfair results. Kenneth Arrow's *The Trade-off between Growth and Equity* analyzes the impacts of redistribution in the direction of equity on efficiency in the allocation of resources over time, recognizing both potential negative impacts on incentives and savings and potential positive impacts on human capital development. In *How Should Egalitarians Cope with Market Risks?*, Elizabeth Anderson considers how the information-aggregation advantages of markets emphasized by Hayek can be pursued without allowing market luck to have a normatively unacceptable effect on life outcomes.

The next two sections cover two famous debates inspired by the provocative work of Louis Kaplow and Steven Shavell. Part II.B surveys the argument over *Fairness versus Welfare*, the title Kaplow and Shavell give to their book on the subject. We begin with two of their articles: *The Conflict between Notions of Fairness and the Pareto Principle* and *Any Non-welfarist Method of Policy Assessment Violates the Pareto Principle*. Kaplow and Shavell argue for channeling *all* normative evaluations of policy through the method of welfare economics, which involves maximizing welfare according to a social welfare function (SWF). In making this point, they are agnostic as to *which* social welfare function we should use, but emphasize that a plausible SWF can incorporate values such as equality (as by seeking to maximize the product of all individual utilities rather than their sum). Kaplow and Shavell also emphasize that fairness preferences enter into the social welfare calculus in just the same way that any other preference does, so the achievement of fair policy has an instrumental value in maximizing welfare. But their most provocative claim is that this instrumental value exhausts all the concern that one should have for fairness (by which they mean all values other than welfare, e.g., morality, dignity, autonomy). Kaplow and Shavell demonstrate that if one gives fairness any independent weight then it is inevitable that there will be situations where the fairness requirement violates the Pareto Principle by making *everyone* worse off. They also seek to undermine the intuitive appeal to claims of fairness by explaining those intuitions as the mere byproduct of (generally functional but crude) moral principles that individuals internalize as children.

The final point of the Kaplow/Shavell thesis – total rejection of any non-welfare method of policy assessment – has generated a substantial critical literature, from which we select some leading articles. We include three pieces from the *Journal of Legal*

Studies symposium on Kaplow and Shavell's book: (1) Richard Craswell, *Kaplow and Shavell on the Substance of Fairness*; (2) Jeremy Waldron, *Locating Distribution*; and (3) Lewis A. Kornhauser, *Preference, Well-Being, and Morality in Social Decisions*. An advantage of including these pieces is that we can include Kaplow & Shavell's direct response: *Fairness versus Welfare: Notes on the Pareto Principle, Preferences, and Distributive Justice*. We then turn to a later criticism by Gillian K. Hadfield, in her article *Feminism, Fairness, and Welfare: An Invitation to Feminist Law and Economics*. Part of this article also concerns the issues in the next section.

Part II.C addresses another contentious and important topic: the best legal mechanisms for redistributing wealth. Again, Louis Kaplow and Steven Shavell have defended a pivotal claim: that, when income redistribution is justified, the legal system should accomplish redistribution only through the system of taxes and transfers. We include their classic article *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*. The alternative that Kaplow and Shavell reject is to redistribute through substantive legal doctrines, such as rules of tort liability or damages that favor the poor. Again, there is a large literature critiquing this claim, from which we select two leading articles: Christine Jolls's *Behavioral Economics Analysis of Redistributive Legal Rules*, and Chris William Sanchirico's *Taxes Versus Legal Rules as Instruments for Equity: A More Equitable View*. We also include the Kaplow and Shavell response to the Sanchirico article, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*.²⁶

Part III presents a sampling of legal and policy applications in which both fairness and efficiency considerations prove important. Three wide-ranging papers take on large questions of institutional and policy design. In *Dividing the Indivisible*, H. Peyton Young examines methods for resolving disputes over goods that are difficult or costly to divide, using examples ranging from international territorial disputes to child custody battles. Matthew D. Adler's *Risk Equity: A New Proposal* examines the distributive implications of risk regulation and uses economic modeling to construct a new probability-based principle of risk equity. In *Climate Change and Discounting the Future: A Guide for the Perplexed*, David Weisbach and Cass R. Sunstein explain how debates over discount rates can be broken down into separate inquiries about intergenerational distributive justice and about the efficient use of resources.

Two classic articles examining the relationship between efficiency and fairness start off our series of doctrinal applications. Boris I. Bittker's piece, *Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities?* points out the conflicting behavioral assumptions underpinning efficiency and equity theories of taxation, and shows how responses to features of a tax system may produce quite counterintuitive and unexpected distributive results. In *Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, Frank I. Michelman delves into the conditions that should trigger governmental compensation, using both a utilitarian calculus (incorporating efficiency gains, demoralization costs, and settlement costs) and a Rawlsian account of fairness.

²⁶ See also Chris William Sanchirico, *Deconstructing the New Efficiency Rationale*, 86 CORNELL L. REV. 1003, 1034-41, 1048-51 (2001) (responding to arguments made in Kaplow and Shavell's response).

Four more recent pieces in other doctrinal areas round out the collection. Ernst Fehr, Oliver Hart, and Christian Zehnder's article, *Contracts as Reference Points—Experimental Evidence*, sheds empirical light on how initial contract terms serve as reference points that shape perceptions of fair conduct, with implications for the choice between rigid and flexible long-term contracts. In *An Attempt to Incorporate Fairness into an Economic Model of Tort Law*, Henrik Lando models the impact of fairness preferences among would-be victims and injurers on the optimal standard of care. A. Mitchell Polinsky and Steven Shavell examine how the perceived fairness of criminal sanctions influences the optimal combination of probability and severity of punishment in *The Fairness of Sanctions: Some Implications for Optimal Enforcement*.²⁷ Turning to family law, Jon Elster's piece *Solomonic Judgments: Against the Best Interests of the Child* uses a cost-conscious framework that draws on both utilitarianism and Rawlsian notions of fairness to challenge the "best interests of the child" standard in custody cases.

Having described the volume's contents, we will now comment on three especially noteworthy topical exclusions. First, we did not engage the topic of discrimination based on protected group characteristics. Such discrimination is an obvious and enormously important source of unfairness, and one with well-recognized connections to both law and economics. To do this area of the literature justice, however, would have meant devoting a substantial part of this collection to a field that has received considerable independent attention and for which at least one excellent guide to the literature already exists.²⁸

Second, we devoted only a small portion of the volume to questions of tax policy, an area in which both economic analysis and fairness loom especially large. Again, our decision was driven by the fact that this large and interesting field has been expertly reviewed in prior literature, including within a prior volume in this series.²⁹

Third, we did not directly engage questions of fairness and efficiency in public benefits policies, topics that are typically surveyed in public finance textbooks.³⁰ However, as already noted, we extensively cover a core debate on whether distributive results are better pursued through tax and transfer programs rather than through legal rules.

We also excluded some material for format reasons. With rare exceptions, we opted for relatively brief contributions in order to expose readers to a broad spectrum of

²⁷ While Polinsky and Shavell focus on the fairness-based utility and disutility that penalties generate, penalty levels (and other features of law that make them seem more or less fair) could influence compliance. See, e.g., Emanuela Carbonara, Francesco Parisi, & Georg von Wangenheim, *Unjust Laws and Illegal Norms*, 32 INT'L REV. L. & ECON. 285 (2012) (modeling connections between sanctions and norm-based backlash); Peter Verboon & Marius van Dijke, *When Do Severe Sanctions Enhance Compliance? The Role of Procedural Fairness*, 32 J. ECON. PSYCH. 120 (2011) (examining how procedural fairness interacts with sanction severity to increase compliance).

²⁸ John J. Donohue, *Antidiscrimination Law*, in 2 HANDBOOK OF LAW AND ECONOMICS 1387 (Oxford UK: Elsevier, A. Mitchell Polinsky & Steven Shavell, eds., 2007); see also 2 ECONOMICS OF LABOR AND EMPLOYMENT LAW, Part II, (Northampton MA: Edward Elgar Publishing, John J. Donahue, ed. 2007); Symposium on the Law and Economics of Race, 41 JOURNAL OF LEGAL STUDIES 321 (2012).

²⁹ THE ECONOMICS OF TAX LAW (Northampton MA: Edward Elgar Publishing, David A. Weisbach, ed., 2008).

³⁰ See, e.g., HARVEY S. ROSEN & TED GAYER, PUBLIC FINANCE, Part III (New York NY: McGraw-Hill/Irwin, 9th ed. 2010).

perspectives and topics. We were also largely limited to journal contributions rather than sections of books. There are a number of important books that deserve mention here, however, including Matthew D. Adler, *Well-Being and Fair Distribution: Beyond Cost-Benefit Analysis* (New York NY: Oxford University Press, 2011), Jon Elster, *Local Justice: How Institutions Allocate Scarce Goods and Necessary Burdens* (New York NY: Russell Sage Foundation, 1992), Louis Kaplow and Steven Shavell, *Fairness versus Welfare* (Cambridge MA: Harvard University Press, 2002), Hervé Moulin, *Cooperative Microeconomics: A Game-Theoretic Introduction* (Princeton NJ: Princeton University Press, 1995), and H. Peyton Young, *Equity: In Theory and Practice* (Princeton NJ: Princeton University Press, 1995).

There is much more that could be said by way of introduction, but we do not want to stand any longer between our readers and the interesting materials that follow. We hope that the collection will spark new work in this field, and convince the skeptical that fairness holds an important place in the economic analysis of law.

Readers with comments should address them to:

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