

Normative Failure Theory of Law

Robert Cooter

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NORMATIVE FAILURE THEORY OF LAW

Robert Cooter†

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INTRODUCTION

The state can impose law from the top down by enacting novel obligations, as illustrated by most regulatory law; or, alternatively, law can grow from the bottom up by enforcing social norms.¹ To illustrate from the common law, in the eighteenth century, Lord Mans-

† Herman F. Selvin Professor of Law, Boalt Hall School of Law, University of California at Berkeley. I am grateful for comments from Jeffrey Harrison and the participants in the *Cornell Law Review* Symposium, *The Nature and Sources, Formal and Informal, of Law*, March 1-2, 1997. I am also grateful for comments received at the University of Southern California Law Faculty Workshop, April 30, 1997; at the annual meeting of the American Law and Economics Association, May 9, 1997; and from Timur Kuran.

¹ The assimilation of bills of exchange and negotiable instruments into the common law in the eighteenth century is well documented. See, e.g., J. MILNES HOLDEN, *THE HISTORY OF NEGOTIABLE INSTRUMENTS IN ENGLISH LAW* 99-144 (1955) (providing the traditional view of this development). For a revised view, see JAMES STEVEN ROGERS, *THE EARLY HISTORY OF THE LAW OF BILLS AND NOTES* 210-22 (1995) (stressing that Lord Mansfield immersed himself in the minutiae of business practice in order to extract the best principles from it). I benefitted from discussions on this point with Dan Coquillette, James Gordley, and Jim Rogers.

field modernized English commercial law by scrutinizing businesses in order to identify and enforce the best commercial practices. Similarly, when Professor Llewellyn directed the drafting of the Uniform Commercial Code, he identified the best commercial practices of the day and wrote them into the Code.² In these examples, state law builds upon pre-existing social norms; hence the phrase, "law from order."³

Some scholars believe that bottom-up law, like the human appendix, is a vestigial organ that modernization will remove.⁴ I believe, to the contrary, that the urgency of bottom-up law increases with economic and social complexity. As society diversifies and businesses specialize, state officials struggle to keep informed about the changing practices of people, and people struggle to make lawmakers respond to changing practices. To loosen these constraints on information and motivation, law must decentralize. Decentralized law requires guidance from a theory of social norms, which is the subject of this Article.

Most social and business practices would not benefit from state enforcement, because of the latter's rigidity and high transaction costs. Consequently, the state should not enforce many moral obligations, such as the promise to be home on time for dinner. For other norms, however, such as the promise to deliver coal to a steel mill, state enforcement increases the ability of parties to cooperate. The state should raise such norms to the level of law and enforce them. In an environment of open competition, business practices tend to evolve rapidly towards efficiency, which benefits the nation. Without open competition, however, harmful business norms can create monopoly power or distort consumer information; these incomplete markets can impose external costs. The state should suppress harmful norms, such as the collusive and monopolistic practices of cartels, and fill gaps in norms with laws, as when pollution outruns responsibility.

The state's decision to ignore, strengthen, or undermine social norms needs guidance from a theory with comprehensive vision. A comprehensive theory of social norms draws upon various developments in the humanities, social sciences, and law. This Article focuses

² See Ingrid Michelsen Hillinger, *The Article 2 Merchant Rules: Karl Llewellyn's Attempt to Achieve the Good, the True, the Beautiful in Commercial Law*, 73 GEO. L.J. 1141, 1151-60 (1985).

³ See Robert D. Cooter, *Law From Order*, in *A NOT-SO-DISMAL SCIENCE: A BROADER, BRIGHTER APPROACH TO ECONOMIES AND SOCIETIES* (J. Mancur Olson & S. Kahkonen eds., forthcoming 1998).

⁴ For example, John Salmond concluded that customary law is important in the early stages of legal development, but gradually cedes its place to statutes when "the state has grown to its full strength." GLANVILLE WILLIAMS, *SALMOND ON JURISPRUDENCE* 234 (11th ed. 1957).

upon aspects of a comprehensive theory of social norms suitable for economic analysis.

Just as regulations ideally correct failures in markets, laws ideally correct failures in social norms. No law is required when the "market" for social norms works, but when it fails, law may improve the situation by enforcing a beneficial social norm, suppressing a harmful social norm, or supplying a missing obligation. The theory of normative failures is a diagnostic tool for explaining if, when, and how the state should intervene by imposing law.

This Article is divided into four main parts. After discussing precursors in Part I, Part II defines "social norm" and operationalizes the definition by connecting it to economic analysis. Part III develops a model of morality. Finally, Part IV applies models of morality to law, showing how different forms of normative failure require different kinds of corrective laws.

Unlike philosophical or theological theories, models organize morality according to the causes of its persistence. Individuals committed to one moral norm often compete with uncommitted individuals and with individuals committed to another norm. Models of morality explain how a commitment can persist in competition with noncommitment and with other commitments. I will characterize some moral obligations that compete successfully and persist. In an evolutionary equilibrium, all strategies that persist enjoy equal payoffs. An analysis of equilibria identifies normative failures and diagnoses them. This diagnosis provides a guide to their correction. Thus, models of morality are diagnostic tools of normative failure that can guide state lawmaking.

I

PRECURSORS

This Article has various intellectual precursors. Philosophers have labored over the questions, "What is law?", and, "What are the conditions under which a law exists?"⁵ Legal scholars, however, underestimated the importance of social norms until empirical research proved that inchoate social norms often control behavior in spite of the law. To illustrate, American businesses frequently remain rationally ignorant of the legal consequences of the contracts that they sign,⁶ small businesses in Taiwan often borrow outside the scope of

⁵ See, e.g., H.L.A. HART, *THE CONCEPT OF LAW* 1-17 (2d ed. 1994) (exploring the foundations of a legal system); JOSEPH RAZ, *THE CONCEPT OF A LEGAL SYSTEM* 121-205 (2d ed. 1980) (discussing elements of legal systems).

⁶ See Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 *AM. SOC. REV.* 55, 58-61 (1963).

formal legal regulation,⁷ and many Peruvian businesses systematically break the law to circumvent excessive regulations.⁸

The formal analysis of social norms is developed by applying game theory.⁹ The economic analysis of social norms draws upon a fundamental result in game theory: one-shot games with inefficient solutions (e.g., Prisoners' Dilemma) often have efficient solutions when repeated between the same players.¹⁰ This generalization grounds the "utilitarianism of small groups," by which I mean the tendency of small groups to develop efficient rules for cooperation among members.

The utilitarianism of small groups has been demonstrated for cattle ranchers,¹¹ Chinese traders,¹² medieval merchants,¹³ and modern merchant associations.¹⁴ Research on property rights has revealed variety and detail in the political arrangements by which small groups manage their assets.¹⁵ Utilitarianism applies to social groups whose

⁷ See Jane Kaufman Winn, *Relational Practices and the Marginalization of Law: Informal Financial Practices of Small Businesses in Taiwan*, 28 L. & SOC'Y REV. 193, 211-25 (1994).

⁸ See HERNANDO DE SOTO, *THE OTHER PATH: THE INVISIBLE REVOLUTION IN THE THIRD WORLD* 59-92 (June Abbott trans., Harper & Row 1989).

⁹ See, e.g., MICHAEL TAYLOR, *THE POSSIBILITY OF COOPERATION* (1987) (developing a theory of collective action with game theory); EDNA ULLMANN-MARGALIT, *THE EMERGENCE OF NORMS* (1977) (providing a rational reconstruction of the formal features of states of social interaction in which norms emerge); Jack Hirshleifer, *Evolutionary Models in Economics and Law: Cooperation Versus Conflict Strategies*, 4 RES. L. & ECON. 1 (1982) (using game theory to categorize different ways in which cooperation might fail); Robert Sugden, *Reciprocity: The Supply of Public Goods Through Voluntary Contributions*, 94 ECON. J. 772 (1984) (proposing an economic analysis of nonselfish behavior).

¹⁰ See ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* 3-24 (1984); Drew Fudenberg & Eric Maskin, *The Folk Theorem in Repeated Games with Discounting or with Incomplete Information*, 54 ECONOMETRICA 533, 533-36 (1986).

¹¹ See ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* 52-64 (1991).

¹² See Janet T. Landa, *A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law*, 10 J. LEGAL STUD. 349 (1981); Janet T. Landa, *The Political Economy of the Ethnically Homogeneous Chinese Middleman Group in Southeast Asia: Ethnicity and Entrepreneurship in a Plural Society*, in *THE CHINESE IN SOUTHEAST ASIA* 86 (Linda Y.C. Lim & L.A. Peter Gosling eds., 1983).

¹³ See Avner Greif, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition*, 83 AM. ECON. REV. 525 (1993); Paul R. Milgrom et al., *The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs*, 2 ECON. & POL. 1 (1990).

¹⁴ See Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992) [hereinafter Bernstein, *Diamond Industry*]; Lisa Bernstein, *The Newest Law Merchant: Private Commercial Law in the United States* (Feb. 7, 1995) (unpublished manuscript on file with the Northwestern University Law School Library).

¹⁵ See, e.g., ELINOR OSTROM, *GOVERNING THE COMMONS: THE EVOLUTION OF INSTITUTIONS FOR COLLECTIVE ACTION* (1990); Thráinn Eggertsson, *Analyzing Institutional Successes and Failures: A Millennium of Common Mountain Pastures in Iceland*, 12 INT'L REV. L. & ECON. 423 (1992) (focusing on the structure and consequences of property rights in communal mountain pastures); Robert C. Ellickson, *Property in Land*, 102 YALE L.J. 1315, 1335-41

members repeatedly interact with each other, such as the Berkeley Chess Club, but not to social categories of people who seldom interact, such as chess players in California.¹⁶ Furthermore, one group may develop norms that benefit its members by subordinating people from other groups.¹⁷

My analysis of social norms combines competing theories of externalities. Pigou viewed externalities as a market failure that law should correct.¹⁸ Samuelson's distinction between public and private goods increased the mathematical precision of Pigou's approach.¹⁹ This tradition has a clear prescription: markets for private goods, government for public goods, taxes for externalities. Coase challenged this tradition by arguing that externalities can be cured in the market, provided that transaction costs do not obstruct private bargains.²⁰ This Article retains Coase's view that markets cure many externalities, but rejects his view that bargaining provides the mechanism. Instead, this Article proposes a mechanism with better empirical support—social norms.

In the 1970s, economists drawing upon the analysis of externalities and public goods reached a remarkable consensus concerning the intellectual framework for analyzing and justifying state regulation of the economy. According to this framework, a *prima facie* case for public intervention requires a demonstration of the failure of a free market.²¹ A failure exists when a free market departs so far from perfect competition as to impair its performance. Tests for market fail-

(1993) (discussing the establishment of land regimes for three separate pioneer settlements); Donald N. McCloskey, *The Economics of Enclosure: A Market Analysis*, in EUROPEAN PEASANTS AND THEIR MARKETS 123 (William N. Parker & Eric L. Jones eds., 1975) (detailing the enclosure movement in the eighteenth and nineteenth centuries); Donald N. McCloskey, *The Persistence of English Common Fields*, in EUROPEAN PEASANTS AND THEIR MARKETS, *supra*, at 73 [hereinafter McCloskey, *Persistence*] (examining the change in efficiency of English agriculture attributable to the enclosure of open fields).

¹⁶ See Eric A. Posner, *The Regulation of Groups: The Influence of Legal and Nonlegal Sanctions on Collective Action*, 63 U. CHI. L. REV. 133, 137-44 (1996).

¹⁷ See George A. Akerlof, *A Theory of Social Custom, of Which Unemployment May Be One Consequence*, 94 Q.J. ECON. 749, 749-53 (1980); George A. Akerlof, *Discriminatory, Status-Based Wages Among Tradition-Oriented, Stochastically Trading Coconut Producers*, 93 J. POL. ECON. 265, 265-66 (1985); Richard H. McAdams, *Cooperation and Conflict: The Economics of Group Status Production and Race Discrimination*, 108 HARV. L. REV. 1005, 1013-17 (1995).

¹⁸ A.C. PIGOU, *THE ECONOMICS OF WELFARE* 329-35 (4th ed. 1960).

¹⁹ Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. & STAT. 387 (1954); see also William J. Baumol, *On Taxation and the Control of Externalities*, 62 AM. ECON. REV. 307 (1972) (asserting that the conclusions of the Pigouvian traditions are impeccable); Paul A. Samuelson, *Diagrammatic Exposition of a Theory of Public Expenditure*, 37 REV. ECON. & STAT. 350 (1955) (presenting a mathematical exposition of public expenditure theory).

²⁰ R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

²¹ See, e.g., STEPHEN BREYER, *REGULATION AND ITS REFORM* 15-35 (1982) (asserting that the justification for regulatory intervention arises out of the market's inability to deal with particular structural problems); CHARLES L. SCHULTZE, *THE PUBLIC USE OF PRIVATE INTER-*

ure are developed through general equilibrium theory.²² A conclusive case for regulation requires a further demonstration that a proposed remedy would succeed politically, and would not be subverted by government bureaucracy or interest groups. Tests for political failure are developed through regulation and collective choice theory.²³ Economists of different political persuasions usually agree about this general framework, even though they disagree about the conclusions its application yields.

Economics struggles to comprehend normative commitment. The theory of cooperative games, which requires players to have normative commitments, languished while the theory of noncooperative games flourished. To illustrate, the classic textbook on game theory devotes a chapter to cooperative games,²⁴ whereas one of the best modern books on the subject omits it.²⁵ By omitting the theory of cooperative games, the authors favor purity over reality. In reality, players who "irrationally" commit to particular norms often do better historically and in experimental games than those who do not.²⁶ Microeconomics typically treats morality as an "exogenous taste," without explaining commitment.²⁷

Promising new developments in analyzing morality come from evolutionary economics.²⁸ In evolutionary models, normative commitment flourishes to the extent that a competitive environment rewards it. Moral commitment imposes self-restraint that sometimes conveys an advantage in competition with others.²⁹ The emotions provide a biological basis for commitment.³⁰ A prominent philosopher claims that rationality also provides a basis for commitment. According to David Gauthier, the fact that a person gains an advantage by making a

EST 35-46 (1977) (concluding that regulation may be the best alternative when there are market failures).

²² See, e.g., KENNETH J. ARROW & F.H. HAHN, *GENERAL COMPETITIVE ANALYSIS* (1971).

²³ See GEORGE J. STIGLER, *THE CITIZEN AND THE STATE* (1975); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976). For a review of the voluminous public-choice literature, see DENNIS C. MUELLER, *PUBLIC CHOICE II* (rev. ed., 1989).

²⁴ R. DUNCAN LUCE & HOWARD RAIFFA, *GAMES AND DECISIONS* 114-54 (1957).

²⁵ DREW FUDENBERG & JEAN TIROLE, *GAME THEORY* (1991).

²⁶ See AXELROD, *supra* note 10, at 173.

²⁷ See, e.g., Avner Greif et al., *Coordination, Commitment, and Enforcement: The Case of the Merchant Guild*, 102 J. POL. ECON. 745, 764-71 (1994); Timur Kuran, *Islamic Economics and the Islamic Subeconomy*, J. ECON. PERSP., Fall 1995, at 155, 167-69; Milgrom et al., *supra* note 13, at 6-14.

²⁸ See, e.g., Abhijit Banerjee & Jørgen W. Weibull, *Evolution and Rationality: Some Recent Game Theoretic Results*, in 2 *ECONOMICS IN A CHANGING WORLD: PROCEEDINGS OF THE TENTH WORLD CONGRESS OF THE INTERNATIONAL ECONOMIC ASSOCIATION* 90 (Beth Allen ed., 1996).

²⁹ See Robert H. Frank, *If Homo Economicus Could Choose His Own Utility Function, Would He Want One with a Conscience?*, 77 AM. ECON. REV. 593, 594-602 (1987).

³⁰ See ROBERT H. FRANK, *PASSIONS WITHIN REASON: THE STRATEGIC ROLE OF THE EMOTIONS* 5-7 (1988).

commitment provides a reason for carrying through later, even though the person can subsequently gain an advantage by not following through.³¹ In experimental economics, the initial discovery of the resilience of moral commitment has yielded to progressive refinements that explain what people are committed to.³² Social psychologists have accumulated impressive evidence that most people conform to laws based on moral rules to which they are committed. According to Tyler, moral commitment to particular rules proves more important for most people's obedience to law than general respect for law or fear of punishment.³³

Proponents of decentralization have long admired social norms because they arise spontaneously, outside the state.³⁴ Economic analysis reveals a surprising level of efficiency in common law rules, which theorists have struggled to explain.³⁵ A recent explanation assumes that judges enforce social norms, and social norms evolve towards efficiency.³⁶

I have briefly reviewed analytical research by social scientists that has revived interest among legal scholars in social norms. To illustrate this renewed interest among lawyers, the *University of Pennsylvania Law Review* recently devoted an entire issue to the subject of social norms.³⁷

II

PREFACE TO A MODEL

In this Article, I generalize and extend some of my previous work on social norms.³⁸ To develop a model of morality, I must define terms and operationalize the definitions.

³¹ DAVID GAUTHIER, *MORALS BY AGREEMENT* 165-89 (1986).

³² See Elizabeth Hoffman et al., *Preferences, Property Rights, and Anonymity in Bargaining Games*, in 7 *GAMES & ECON. BEHAV.* 346 (1994).

³³ TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* 44-45 (1990).

³⁴ See, e.g., ELLICKSON, *supra* note 11, at 4-6; FRIEDRICH A. HAYEK, *THE ROAD TO SERFDOM* 72-87 (1944); BRUNO LEONI, *FREEDOM AND THE LAW* 146-52 (expanded 3d ed. 1991); Paul H. Rubin, *Growing a Legal System in the Post-Communist Economies*, 27 *CORNELL INT'L L.J.* 1, 7-13 (1994).

³⁵ See, e.g., Robert Cooter & Lewis Kornhauser, *Can Litigation Improve the Law Without the Help of Judges?*, 9 *J. LEGAL STUD.* 139 (1980); George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 *J. LEGAL STUD.* 65 (1977); Paul H. Rubin, *Why Is the Common Law Efficient?*, 6 *J. LEGAL STUD.* 51 (1977).

³⁶ See Robert Cooter, *Structural Adjudication and the New Law Merchant: A Model of Decentralized Law*, 14 *INT'L REV. L. & ECON.* 215 (1994).

³⁷ Symposium, *Law, Economics, & Norms*, 144 *U. PA. L. REV.* 1643 (1996).

³⁸ Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 *U. PA. L. REV.* 1643 (1996) [hereinafter Cooter, *Decentralized Law*]; Robert D. Cooter, *The Theory of Market Modernization of Law*, 16 *INT'L REV. L. & ECON.* 141 (1996).

A. Definitions

Obligation differs from inclination. To illustrate, men take off their hats in church from obligation, but they take off their hats in a boiler room from inclination.³⁹ Many economists apparently believe that a behavioral theory can dispense with the distinction between obligations and inclinations.⁴⁰ This view is mistaken. Obligations affect behavior in distinctively different ways from inclinations.⁴¹ Later I consider these distinctive effects in detail.

Different types of norms correspond to different meanings of "norm." Philosophers usually use "norm" to refer to what people ought to do.⁴² According to this usage, the obligation to remove one's hat in church implies the existence of a norm, whereas the inclination to remove one's hat in a boiler room implies the existence of a regularity. Unlike philosophers, social scientists sometimes use "norm" to mean average behavior. For example, statisticians talk about the "normal distribution," and sociologists sometimes use "norm" to mean what people normally do, as opposed to what deviants do. These statistical and sociological uses identify norms with regularities, which may differ from inclinations or obligations.

I believe that decentralizing law requires internalizing obligations. Internalization especially occurs through socialization, which teaches young people the conventional virtues at the core of morality. In this Article, I focus upon consensus obligations in the core of conventional morality, not moral controversy or critical morality.

An analysis of consensus obligations must distinguish between what people say and what they do. Everyone may say that people ought to do something that they do not do. For example, used car dealers may protest their truthfulness to customers and then tell lies when the truth proves inconvenient. More often, however, words affect deeds. To illustrate, most men say that they ought to take their hats off in church, and this fact partly explains why they do it. Obligations that influence behavior are most important to decentralizing law. Consequently, this Article focuses upon the class of social norms consisting in effective consensus obligations (ECOs).

³⁹ Women used to put their hats on in church, and men still put their hats on in synagogue. The particular content of the obligation is unimportant to my argument.

⁴⁰ This view developed forcefully in the "ordinalist revolution" of the 1930s, which established a form of positivism as the dominant philosophy of economics. For a discussion with references, see Robert Cooter & Peter Rappoport, *Were the Ordinalists Wrong About Welfare Economics?*, 22 J. ECON. LITERATURE 507 (1984).

⁴¹ See Amartya K. Sen, *Maximization and the Act of Choice*, 65 ECONOMETRICA 745 (1997); Amartya K. Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 PHIL. & PUB. AFF. 317 (1977) [hereinafter Sen, *Rational Fools*].

⁴² See, e.g., GEORG HENRIK VON WRIGHT, *NORM AND ACTION* 1-16 (1963).

Notice that a close connection exists between an ECO and a "law" in the positive theory of law. In its early form in English jurisprudence, the positive theory asserted that law is the command of a sovereign, where a sovereign is someone whom others obey and who does not obey anyone.⁴³ Generalizing, the "sovereign" becomes the process for making laws stipulated in higher level laws. A law created by following the correct procedures has the right "pedigree."⁴⁴ In the modern formulation, a law regulating behavior is an effective obligation with the right pedigree.⁴⁵ Similarly, I focus upon effective obligations that a community creates by consensus.

Agreement produces a true consensus, whereas coercion produces a false consensus. To produce a true consensus, obligations require justification. The necessity of justification restricts the behaviors that can become socially obligatory. To illustrate, accepted standards of morality cannot justify the proposition, "Everyone but me should tell the truth." Later, I discuss how economists can analyze the justification of social obligation. For now, I note that by eliminating strategies that cannot sustain social obligation, we can alleviate the problem of too many equilibria that plagues game theory.⁴⁶

B. Operations

To construct an economic model, I need to operationalize the definition of an ECO. Economists model the transmission of information by using signaling theory. A consensus, which exists when everyone agrees, resembles a uniform signal, by which I mean a situation in which everyone transmits an identical signal. Therefore, I identify the existence of a consensus obligation with a uniform signaling equilibrium. To illustrate, people agree that they ought to tell the truth; this belief influences their behavior, even though they sometimes lie.

Now I turn to the effectiveness of a social obligation. People sometimes say that they will do one thing, and ultimately do another. An effective norm changes behavior by increasing the level of obedience through two distinct means—self-restraint and punishment. The extent of self-restraint and informal punishment depends upon the extent to which people internalize the obligation. I will now analyze the elusive concept of internalization.

⁴³ See JOHN AUSTIN, *THE PROVINCE OF JURISPRUDENCE DETERMINED* 136-37 (Legal Classics Library 1984) (1832).

⁴⁴ See RONALD DWORIN, *The Model of Rules I & II*, in *TAKING RIGHTS SERIOUSLY* 14, 17 (1977).

⁴⁵ See HART, *supra* note 5, at 97-107; RAZ, *supra* note 5, at 147-56.

⁴⁶ The Folk Theorem formulates the problem of multiple equilibria. See Fudenberg & Maskin, *supra* note 10, at 537.

Internalization resembles the game-theory concept of commitment.⁴⁷ Commitment is an action a player takes to change his payoffs, such as a commander burning the bridges behind his army to commit them to advancing, or an alcoholic drafting a check to mail to the political party that he hates if he resumes drinking. By raising the costs of the disfavored action, commitments typically reduce freedom. Similarly, by narrowing the set of permitted actions, moral commitment reduces the actor's freedom.

Psychologists often study the internalization of obligations.⁴⁸ One approach conceives of internalization as attaching guilt to forbidden actions, thus raising their psychological cost.⁴⁹ Similarly, economists and utilitarians can understand internalization as raising the subjective cost of violating an obligation.

A loftier conception of internalization, based not on guilt but on reason, is found in Kant's philosophy⁵⁰ and Kohlberg's psychology.⁵¹ I use the term "loftier" because these theories suppose that people can act from respect for the law, not merely to avoid guilt or unpleasantness.⁵² This approach rejects the model of desire, according to which a desire explains every act,⁵³ and endorses the model of reason, according to which the perception of rightness can motivate behavior.⁵⁴ Anti-utilitarians can understand internalization as self-imposed constraint upon action.

An intermediate position between utilitarianism and anti-utilitarianism conceives of the committed actor as utility maximizing subject to side constraints.⁵⁵ The side constraints for moral actors come from internalized obligations, as do external limits that technology and wealth impose. For purposes of my analysis, the precise mechanism of commitment—whether guilt or respect—need not concern us, so

⁴⁷ See Sen, *Rational Fools*, *supra* note 41, at 326-29.

⁴⁸ See, e.g., SIGMUND FREUD, *THE EGO AND THE ID* 18-29 (James Strachey ed. & Joan Riviere trans., W.W. Norton & Co. 1960) (1923); JEAN PIAGET, *THE MORAL JUDGMENT OF THE CHILD* (Marjorie Gabain trans., 1932); MUZAHER SHERIF, *THE PSYCHOLOGY OF SOCIAL NORMS* 13-108 (1936); Robert B. Cialdini et al., *A Focus Theory of Normative Conduct: A Theoretical Refinement and Reevaluation of the Role of Norms in Human Behavior*, in 24 *ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY* 201 (Mark P. Zanna ed., 1991); Lawrence Kohlberg, *Stage and Sequence: The Cognitive-Developmental Approach to Socialization*, in *HANDBOOK OF SOCIALIZATION THEORY AND RESEARCH* 347, 409-14 (David A. Goslin ed., 1969).

⁴⁹ See *supra* note 48.

⁵⁰ IMMANUEL KANT, *CRITIQUE OF PURE REASON* 430-35 (Norman Kemp Smith trans., unabr. ed., St. Martin's Press 1929) (1781).

⁵¹ Kohlberg, *supra* note 48, at 409-14.

⁵² KANT, *supra* note 50, at 643-44; Kohlberg, *supra* note 48, at 413.

⁵³ See Debra Satz & John Ferejohn, *Rational Choice Theory and Folk Psychology* (1997) (unpublished manuscript, on file with authors).

⁵⁴ See THOMAS NAGEL, *THE POSSIBILITY OF ALTRUISM* 79-89 (1970).

⁵⁵ See ROBERT NOZICK, *ANARCHY, STATE, AND UTOPIA* 26-30 (1974).

long as one accepts the proposition that internalization changes behavior.

After an obligation is internalized, it can conflict with an inclination. Suppressing an inclination and performing an obligation requires strength of will. Since Aristotle, moral philosophers have analyzed the problem of weakness of will (technically known as *akrasia*).⁵⁶ Economists usually adopt a model of decisionmaking that precludes internal conflict, but some economists have analyzed the problem under the rubric of “self-monitoring” or the “divided self.”⁵⁷ At least one paper applies such a model to crimes and torts.⁵⁸

Internalizing a norm has two important effects upon behavior, which I call self-restraint and righteousness. By self-restraint, I mean the willingness of a person to conform to an obligation that conflicts with an inclination. By righteousness, I mean the willingness of someone who internalizes an obligation to punish other people for violating it.

Later, I show that self-restraint and righteousness affect society in fundamentally different ways. Righteousness motivates punishment, and punishing violators changes the aggregate level of conformity to a norm. I call the resulting change a “punishment-induced equilibrium.” In contrast, self-restraint changes *who* conforms to a social norm without changing aggregate conformity. For now, I postpone explaining why self-restraint affects individuals and not groups.

Figure 1 summarizes how I operationalize ECOs. I identify internalization with commitment, consensus with a uniform signal, and effectiveness with a punishment-induced equilibrium.

Figure 1: “Social Norms” Defined and Operationalized	
<u>Define</u>	<u>Operationalize</u>
obligation	commitment
consensus	uniform signal
effective	punishment-induced equilibrium

⁵⁶ See S.L. HURLEY, *NATURAL PERSONS: PERSONALITY AND POLITY* 4 (1989).

⁵⁷ See, e.g., THOMAS C. SCHELLING, *CHOICE AND CONSEQUENCE* 57-112 (1984); Richard H. Thaler & H.M. Shefrin, *An Economic Theory of Self-Control*, 89 J. POL. ECON. 392 (1981); see also *THE MULTIPLE SELF* (Jon Elster ed., 1985) (collected essays) (discussing “the multiple self”).

⁵⁸ See Robert D. Cooter, *Lapses, Conflict, and Akrasia in Torts and Crimes: Towards an Economic Theory of the Will*, 11 INT’L REV. L. & ECON. 149 (1991).

III A MODEL OF MORALITY

Having operationalized terms, I will now outline a general model of morality.

A. The Possibility of Commitment

Commitment to a moral rule constrains an actor's choices, and in many circumstances, fewer choices imply worse outcomes. If so, how can committed actors succeed in competition with uncommitted actors? This question also implicates the ability of morality to persist in a competitive world.

The unconstrained actor's apparent advantage comes from focusing on problems of distribution. In pure distribution games, which are also called zero-sum games or games of pure conflict, the parties have no basis for cooperating with each other.⁵⁹ Instead of cooperating, each tries to beat the other. A game of pure distribution is like a fight, and moral commitment is like fighting with one arm tied behind your back. To appreciate the advantages of commitment, focus upon cooperation rather than conflict. In games of production, unlike in zero-sum games, the parties can create joint value. Cooperation facilitates production, and commitment facilitates cooperation. Therefore, in games of production a committed actor often gains an advantage by increasing the level of cooperation.

To illustrate, Max Weber believed that the Quakers' commitment to sell at the "just price" instead of haggling to get a higher price, gave them a distinct advantage in marketing industrial goods.⁶⁰ In modern language, the moral commitment of the Quakers facilitated mass marketing by reducing transaction costs and overcoming asymmetrical information.

Another illustration comes from the "agency game," which is central to modern theories of contracts.⁶¹ Assume that the principal must decide whether to place assets under the agent's control. If the agent receives control, he can appropriate the assets, which redistributes the value of the assets from principal to the agent. Alternatively, the agent can cooperate, producing a surplus that can be divided between the parties.

⁵⁹ See FUDENBERG & TIROLE, *supra* note 25, at 4; JOHN VON NEUMANN & OSKAR MORGENTHAU, *THEORY OF GAMES AND ECONOMIC BEHAVIOR* 47 (1944).

⁶⁰ MAX WEBER, *THE PROTESTANT ETHIC AND THE SPIRIT OF CAPITALISM* 144-54 (Talcott Parsons trans., Charles Scribner's Sons 1958) (1904).

⁶¹ See ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 161-202 (2d ed. 1997); *see also* Cooter, *supra* note 3 (using the "agency game" as a basis for the development of contract theory).

In this illustration, appropriation yields higher immediate profits for the agent than cooperation. Appropriation, however, yields a long-run disadvantage relative to cooperation. Principals usually retain agents who cooperate, whereas principals dismiss agents who get caught appropriating. Consequently, appropriating agents form unstable relationships and repeatedly have to search for new partners—a process that consumes time and resources. Cooperating agents, in contrast, form stable relationships and seldom have to search for new partners. Thus, cooperators frequently enjoy a modest payoff while appropriators only occasionally enjoy a high payoff.

B. Evolutionary Equilibrium

In this section I will characterize an equilibrium that exists when only some people commit to moral rules. Think of commitment and noncommitment to morality as alternative strategies in a game. Which of these strategies will survive in competition with the other? Competition tends to eliminate below-average strategies, and propels the game toward a situation in which every surviving strategy earns the same payoff. By an *internal evolutionary equilibrium*, I mean a situation in which some players commit to morality and others do not, with both kinds of players earning the same payoff.

To illustrate, in the agency game, agents who commit to morality cooperate, whereas agents who do not commit either appropriate or cooperate, depending upon which activity earns a higher payoff. I previously explained that cooperators form stable relationships, seldom search for new partners, and thus frequently earn a modest payoff. Appropriators, however, form unstable relationships, often search for new partners, and thus only occasionally earn a high payoff. An internal equilibrium is a situation in which both kinds of agents exist, with each earning the same average payoff.

It is not hard to see why an internal equilibrium may exist. As the number of appropriators increases, more of them search for partners at each point in time. As more agents search, finding partners becomes more difficult. Cooperators form enduring relationships, so the difficulty in finding a new partner affects them less. In contrast, appropriators form temporary relationships, so the difficulty in finding a new partner affects them more. This fact can induce a stable equilibrium at a point where some agents cooperate and others appropriate.⁶²

⁶² In the agency game, a stable internal equilibrium usually exists when an increase in the proportion of appropriators causes the expected payoff from appropriation to decrease. Equivalently, a stable internal equilibrium usually exists in commodity markets when an increase in the quantity of production causes the cost of production to increase. See Cooter, *supra* note 3.

To illustrate equilibration, start from a situation with too many appropriators, so that the payoff from cooperating exceeds the payoff from appropriating. In these circumstances, uncommitted agents will switch from appropriating to cooperating, until the payoff from cooperating falls to the same level as the payoff from appropriating.

Alternatively, start from a situation with too many cooperators, so that the payoff from appropriating exceeds the payoff from cooperating. In these circumstances, uncommitted agents will switch from cooperating to appropriating, until the payoff from appropriating falls to the same level as the payoff from cooperating.

Notice that in these examples, the uncommitted actors create the equilibrium by changing their behavior. The actors who make the equilibrium are thus "marginal" in the economic sense. In contrast, the committed actors are not "marginal," and do not create the equilibrium.

To illustrate an interesting application, Brennan and Hamlin observe that personal markets with repeat transactions reward virtue, whereas impersonal markets with one-shot transactions do not reward virtue.⁶³ From this observation they postulate that economic development, which increases the scope of competitive markets, reduces virtue by rewarding it less.⁶⁴ They call this process "economizing on virtue."⁶⁵

C. Ineffectiveness of Self-Restraint

In the preceding account of equilibration, the "marginal" actors who make the equilibrium are uncommitted. This fact has an important consequence for commitment. Commitment leads to self-restraint, but self-restraint does not change the equilibrium. Only marginal actors can change the equilibrium.

To understand the ineffectiveness of self-restraint in competition, consider truth-telling among sellers. In an internal equilibrium, some businesses obey the norm of truth-telling and others violate it. Truthful sellers enjoy repeat purchases from the same customers, whereas dishonest sellers must continually search for new customers. In competitive equilibrium, the profit rate for truth-telling is the same as for lying. Given equal payoffs, some sellers who do not commit to truth-telling will tell the truth solely to maximize their payoffs. I use the term "adventitious" to mean conforming to a norm without committing to it. Adventitious truth-tellers are the marginal sellers who, by changing their behavior, create the equilibrium.

⁶³ Geoffrey Brennan & Alan Hamlin, *Economizing on Virtue*, 6 CONST. POL. ECON. 35, 43-44 (1995).

⁶⁴ *Id.* at 42-46.

⁶⁵ *Id.*

I will now illustrate the ineffectiveness of self-restraint. Beginning from an equilibrium, assume that one of the liars "gets religion," internalizes the norm, and switches to truth-telling. The increase in the number of truth-tellers lowers their rate of return relative to liars, and places the system in disequilibrium. To restore equilibrium, one of the adventitious truth-tellers switches strategies and starts lying. This switch restores equality to the profit rates for the two strategies. The new equilibrium, however, contains the same proportion of truth-tellers and liars as before. Thus, although one dishonest seller "gets religion," this does not change the aggregate level of truth-telling.

I will now clarify this point using a numerical example of the agency game. Assume that sixty agents commit to cooperating, whereas the remaining forty cooperate adventitiously or appropriate, depending upon which behavior earns a higher payoff. Assume that the payoff for cooperating equals the payoff for appropriating when eighty agents cooperate and twenty agents appropriate. Thus, an equilibrium is reached when sixty agents cooperate from commitment, twenty agents cooperate adventitiously, and twenty agents appropriate.

Now, assume that one of the appropriators "gets religion," internalizes the norm, and starts cooperating. The system is now in disequilibrium, with eighty-one cooperators and nineteen appropriators. Equilibrium is restored when one of the adventitious cooperators changes strategy and starts appropriating. In the new equilibrium, the aggregate levels of cooperation and appropriation remain eighty and twenty, respectively. Only the identity of one cooperator and one appropriator has changed.

These illustrations demonstrate that the marginal actors in an evolutionary equilibrium are adventitious conformists, as a result of which, self-restraint in competition does not change the equilibrium proportion of people conforming to a norm.⁶⁶ Self-restraint might prove effective in a different kind of model. To illustrate, commitments that earn below average payoffs can persist because of competitive slack. If morality pays less than amorality, then no one conforms adventitiously and committed actors are marginal. Developing this line of argument requires a disequilibrium analysis. Instead, I turn from self-restraint to punishment, and consider the latter's effects on equilibria.

⁶⁶ I have developed this argument more rigorously elsewhere. See Cooter, *Decentralized Law*, *supra* note 38, at 1657-77; Cooter, *supra* note 3.

D. Effectiveness of Punishment

Internalization typically results in a willingness to punish others, often motivated by a sense of righteousness. Righteousness can succeed in changing aggregate behavior where self-restraint fails. A person who internalizes a norm may punish people who violate it, even at a cost to himself. The prospect of punishment—informal or formal—raises the expected cost of an action, which reduces its frequency. Thus, the willingness of people who internalize a norm to punish violators changes the aggregate level of conformity to it.

To illustrate, consider the preceding example of an industry with some truth-tellers and some liars. A buyer victimized by lies will refuse to deal with that seller in the future. In addition, the victim may broadcast this information to discourage other people from dealing with the liar. The resulting boycott decreases the dishonest seller's profits. Starting from an equilibrium, this fall in profits creates a disequilibrium. Restoring the equilibrium requires a decrease in the number of sellers who lie. Thus, punishment changes the equilibrium proportion of truth-tellers and liars.

For a numerical example, return to the agency game in which an equilibrium exists when sixty agents cooperate from commitment, twenty agents cooperate adventitiously, and twenty agents appropriate. This equilibrium previously assumed that principals punish appropriating agents by terminating the relationship, and that principals do not use reputational punishment. However, this example will show how reputational punishment changes the equilibrium.

Assume that someone who internalizes the norm of cooperation feels righteous anger toward appropriating agents. When victimized, this person blackens wrongdoers' reputations by warning other people against them. This reputational punishment lengthens the expected time that appropriating agents spend searching for uninformed principals, thus causing a fall in the expected payoff from appropriation. To restore equilibrium, the number of appropriating agents must fall relative to the number of cooperating agents. Equilibrium is restored when some appropriators switch to adventitious cooperation. The new equilibrium consists of, say, eighty-five cooperators and fifteen appropriators.

Internalizing a norm makes the victim of a wrong more willing to devote resources to broadcasting information about the wrongdoer. Devoting resources to punishing violators increases the equilibrium level of cooperation. In general, as more people internalize a social norm, the expected punishment from violating it increases, thus causing a decrease in the equilibrium number of violators.

From a technical standpoint, punishing wrongdoers resembles rewarding rightdoers. In either case, increasing punishment or reward

creates a gap in the payoffs of wrongdoers and rightdoers. Although they are not identical, punishments, as well as rewards, can change the equilibrium level of conformity to a norm.⁶⁷ This analysis could discuss reward-induced equilibria, but I will not pursue this detail.

E. Fundamental Instability of Informal Punishment

Informal punishments usually involve rebuking someone, refusing to deal with them, or blackening their reputation. A person who punishes someone in these ways often risks confrontation or revenge. This risk tends to decline as more people join in punishing the wrongdoers. Consequently, the enforcer's cost of punishing decreases as the proportion of enforcers increases.

Interdependent costs in economic models typically create instabilities and multiple equilibria.⁶⁸ For example, if people believe that others will support them, then, as in California, many are willing to rebuke those who smoke in public buildings. Conversely, if people believe that few will support them, then, as in Europe, no one may be willing to rebuke those who smoke in public buildings.

These facts can result in two equilibria, one at a high level of enforcement and one at a low level of enforcement. In between the two equilibria lies a "tipping point." If the system begins at a level of enforcement above the tipping point, it "tips in" to a high level of norm enforcement. Conversely, if the system begins at a level of enforcement below the tipping point, it "tips out" to a low level of norm enforcement.

With multiple equilibria, the place where the system comes to rest depends upon where it started—whether above or below the tipping point. This phenomenon is sometimes called "path dependence,"⁶⁹ because the equilibrium depends upon the path traveled to reach it. Path dependence is the way economic theory accommodates history.

As the number of people willing to punish increases, the cost of informally punishing wrongdoers decreases rapidly, causing instability.⁷⁰ To see why, consider that people may be ranked from "high" to

⁶⁷ For example, if the number of rightdoers exceeds the number of wrongdoers, then more rewards must be paid than punishments extracted in order to reach the same number of people (extensive margin). Rightdoers may respond to rewards differently than wrongdoers respond to punishment (intensive margin). Rightdoing may be easier to observe than wrongdoing (information costs).

⁶⁸ See Peter H. Huang & Ho-Mou Wu, *Emotional Responses in Litigation*, 12 INT'L REV. L. & ECON. 31, 37-38 (1992).

⁶⁹ Models of law with multiple equilibria and path dependence are found in Hirshleifer, *supra* note 9.

⁷⁰ These facts can be analyzed using a curve to depict people's willingness to pay to punish wrongdoers (a demand curve), and a curve indicating the expected cost of punishing wrongdoers (a supply curve). See Cooter, *Decentralized Law*, *supra* note 38, at 1669-75; Robert D. Cooter, *The Rule of State Law and the Rule-of-Law State: Economic Analysis of the*

“low” according to how much they are willing to pay to punish wrongdoers. Recall that a person who punishes risks confrontation or revenge, both of which become less likely as more people participate in punishing. Consequently, the expected cost a person faces for informally punishing falls as more people participate.

If, as the number of enforcers increases, the expected cost falls faster than willingness to pay, then the system cascades toward increasing levels of enforcement. Conversely, if, as the number of enforcers decreases, the expected cost rises faster than willingness to pay, then the system cascades toward decreasing levels of enforcement.

Later, I will explore some additional consequences of multiple equilibria and instability in social norms.

F. Consensus

So far, I have assumed the existence of a consensus about what people ought to do, but now I will consider how a consensus forms.

1. *Uniform Signaling*

Some people commit to particular moral rules and others do not. In many circumstances, people prefer to deal with another person who commits to morality rather than with someone who remains uncommitted. To illustrate, in most circumstances, people prefer that others tell the truth, cooperate, keep promises, play fair, help the community, and so forth.

Most people would hesitate to deal with someone who denies that people have these obligations. In these circumstances, even liars and appropriators condemn lying and appropriating. In general, people increase their opportunities for dealing with others by representing themselves as committed to morality. Thus, most people say that everyone ought to be truthful, cooperative, reliable, and so forth. Most people’s willingness to say these things constitutes a consensus about conventional morality.

The so-called “human virtues” provide an example of how morality promotes cooperation. Since Aquinas, Catholic doctrine distinguished seven cardinal virtues—three theological virtues (faith, hope, and love) and four human virtues (justice, prudence, temperance, and courage).⁷¹ The three theological virtues are viewed as gifts from

Legal Foundations of Development, in ANNUAL WORLD BANK CONFERENCE ON DEVELOPMENT ECONOMICS 1996 191, 197-201 (1997).

⁷¹ The distinction of cardinal virtues into human and theological, and a discussion of each, occurs in questions 61 and 62 of the *Summa Theologica*. 2 ST. THOMAS AQUINAS, *SUMMA THEOLOGICA* PT. 1-11, Qs. 61-62, at 846-53 (Fathers of the English Dominican Province trans., Christian Classics 1981). I am grateful to James Gordley for a discussion of these points.

God, whereas the four human virtues are viewed as habits acquired by acting right.⁷² A person without admiration for the human virtues lacks the motivation necessary to acquire them.⁷³

In many circumstances, people prefer to deal with others who have the human virtues. Because admiring the human virtues is a necessary step toward acquiring them, people declare their admiration for the human virtues to signal that they have acquired them or are trying to do so. A model of the virtues would explain in detail why people want to signal that they have them, as well as why people who have them succeed in competition with others.

In general, a consensus forms about conventional morality when a uniform signal is best for each individual. Uniform signaling, however, involves a paradox. If everyone transmits the same signal, the signal does not convey any information about differences among people. To illustrate, if every agent proclaims that all agents should cooperate and not appropriate, then the agents' proclamations do not distinguish cooperators from appropriators. Nevertheless, an agent will lose business if he departs from this convention by proclaiming that agents have no obligation of loyalty to principals.

I have explained why everyone needs to signal their own commitment to morality by proclaiming their admiration for it. Economists have developed "rat race" models to explain how people lock themselves into a competition to out-do each other.⁷⁴ Moral consensus is a kind of beneficial rat race. Like a rat race, people compete with each other to proclaim their admiration for, and commitment to, morality. The result, however, is beneficial, because the consensus causes some people to internalize morality, which shifts the evolutionary equilibrium toward more cooperation and production.

Moral philosophy often asks such questions as, "Why should I favor the rule that everyone should tell the truth, rather than the rule that everyone but me should tell the truth?" The theory of uniform signaling explains why one should represent oneself as favoring the rule that everyone should tell the truth. Uniform signaling theory thus provides another perspective on Kantian "universalizability."

When economists depict the interaction of people as a point in a multidimensional strategy space, an equilibrium can occur at a "corner" or in the "interior" of the space. A player arrives at a corner because he chooses an extreme value of the variable that he controls, much like a race-car driver who floors the gas pedal. A uniform signal in a population represents a corner equilibrium. Thus, the first row

⁷² See *id.* at 851, 854-57.

⁷³ See *id.* at 854-62.

⁷⁴ See, e.g., A. MICHAEL SPENCE, MARKET SIGNALING: INFORMATIONAL TRANSFER IN HIRING AND RELATED SCREENING PROCESSES 76-87 (1974).

in Figure 2 depicts a uniform signal as a corner equilibrium, with honesty as an example.

Figure 2: Signaling Equilibria		
<u>signal</u>	<u>equilibrium</u>	<u>example</u>
uniform	corner	honesty
complementary	interior	responsibilities
contradictory	none	equality

A good scientific theory runs the risk of disconfirmation by facts. As the equilibria in a game increase, the model's risk of disconfirmation decreases. Many games have too many equilibria for the models to be good science.⁷⁵ However, the consensus requirement dramatically reduces the number of equilibria. In technical terms, many strategies are Nash equilibria,⁷⁶ which cannot sustain social norms because they fail to produce uniform signals. Thus, the consensus requirement increases the scientific value of models of morality.

2. *Complementary*

Most people prefer a meal that is not all vegetables, and a concert that is not all trumpets. Similarly, a modern economy requires many different competencies. Weber and Durkheim stressed that complementary specialization requires individuals to internalize the social norms of particular professions.⁷⁷ To illustrate, education in law imparts different skills, values, and professional norms than education in accounting. A good audit requires more accuracy than creativity, whereas a good plea sometimes requires more creativity than accuracy. While a responsible accountant is different from a responsible lawyer, the professions complement each other in a modern economy.

Unlike honesty, some behaviors benefit from normative diversity rather than universality. For such behaviors, the morality that we most prefer in others depends upon their occupational role. With regard to professionals, people do not agree that a specific type of behavior is universally best, but they may agree about the best behavior for a given role.

⁷⁵ As noted in footnote 46, *supra*, the Folk Theorem formulates the problem of multiple equilibria.

⁷⁶ For an explanation of Nash equilibria, see ERIC RASMUSEN, GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY 22-28 (2d ed. 1994).

⁷⁷ EMILE DURKHEIM, THE DIVISION OF LABOR IN SOCIETY 68-87 (W.D. Halls trans., 1984); WEBER, *supra* note 60, at 27.

This Article will not discuss occupational roles any further, except to connect professional norms to signaling equilibria. Given consensus over diversity, people in different occupational roles will provide different signals about their competency and responsibility. The signaling equilibrium will typically occur in the interior of the strategy space, not at a corner. In the interior, the players balance marginal benefits and costs, which are unbalanced at a corner. The second row in Figure 2 indicates that, instead of being universally best, the responsibilities associated with roles are relatively best, which generates an interior signaling equilibrium.

3. *Controversy*

I have discussed forms of morality that generate consensus. Many moral questions, however, cause disagreement and controversy. Equality provides an example: people disagree over the extent to which individuals ought to share their wealth with others. Disagreement persists because individuals do not benefit from professing admiration for the same thing. Poor people may hope to gain an advantage by proclaiming that everyone ought to share wealth with less fortunate people, but rich people gain little or no advantage from professing that view.

In a business transaction (such as bargaining between the principal and agent over the latter's salary), soft bargaining is a public good because it increases the probability of cooperation, whereas hard bargaining is a public bad because it increases the probability of an impasse. In spite of this fact, a business community is unlikely to develop a norm requiring soft bargaining. To drive a hard bargain, a player must signal that he is a hard bargainer. People who represent themselves as hard bargainers are likely to defend hard bargaining in principle. Consequently, many people will signal that they follow a hard-bargaining strategy. Given this fact, no consensus will emerge that people ought to "soft bargain." Instead of a consensus, a mixture of opinions about the ethics of bargaining will mirror the mixture of equilibrium strategies actually followed.

Moral disagreement causes contradictory signals among people about what they ought to do. Contradictory signals often indicate the absence of a signaling equilibrium. Instead of an equilibrium, different ethical views may contend with each other for people's allegiance. Thus, the third row in Figure 2 depicts equality as an example of a value that elicits contradictory signals without a disequilibrium.

Whereas conventional morality concerns consensus obligations, critical morality concerns contending values. Moral disagreement creates instability and provides part of the dynamic for social change. Moral progress, such as women's suffrage and the abolition of slavery,

occurs when people advocating controversial values gain political power and eventually succeed in creating a consensus in favor of their views. A consensus over values restores a signaling equilibrium. The rules of moral justification require much more elucidation in terms of signaling theory than can be provided here.

IV

NORMATIVE FAILURE THEORY OF LAW

Having developed a model of morality, I will now provide a diagnostic tool for lawmakers by sketching a theory of normative failure. I focus upon the type of normative failure that deficient informal punishment causes. I have argued that the effectiveness of a consensus obligation depends especially upon informal punishment. When informal punishments fail, social norms fail to emerge, or they emerge and do not command enough obedience. To develop the analysis, I distinguish different types of informal punishments, show how they can fail, and explain how law can correct the failures.⁷⁸

A. Types of Punishment

I will first distinguish three general types of wrongdoing with distinctive punishments. People often voluntarily transact with each other, such as when they exchange goods, give gifts, or transmit information. Boycotting is the logical opposite of transacting, so I call boycotting the inherent sanction for transactional wrongdoing, as depicted in the first row of Figure 3.

Figure 3: Sanction		
<u>activity</u>	<u>inherent sanction</u>	<u>reputational sanction</u>
transact	boycott	blame
relate	detach	condemn
belong	exclude; disdain	denounce

People often form relationships with others, such as a business partner, friend, or lover. Whereas transactions are discrete and may occur only once, relationships necessarily endure, at least for awhile. Social norms constrain behavior in relationships, channel the expression of intrinsic values, and direct the flow of extrinsic benefits and costs. The logical opposite of forming an attachment is

⁷⁸ I now use the term "normative failure theory of law." Formerly, I used the term "structure theory of adjudication," because judges applying the theory of normative failure to adjudicate a case will focus on the incentive structures by which social norms evolve. See Cooter, *Decentralized Law*, *supra* note 38, at 1677-94.

detaching. Total detachment ends the relationship, whereas partial detachment impairs it. In a voluntary relationship, the inherent sanction for wrongdoing is detachment, as depicted in the second row of Figure 3.

People often belong to formal or informal groups, such as a circle of friends or a business organization. Social norms control behavior in groups. Since exclusion from a group is the logical opposite of belonging, I say that exclusion is the inherent sanction for wrongdoing in a group, as depicted in the third row of Figure 3.

A person who advances the purposes and values of a group will enjoy the esteem of its members.⁷⁹ Conversely, a person who frustrates the purposes of a group or undermines its values will suffer the disdain of its members. Most people intrinsically value esteem and disdain, so a group can reward and punish its members by modulating esteem and disdain. In Figure 3, I include "disdain" as an inherent sanction of a group.

A person's reputation consists of the public's beliefs about his history of conforming to social norms or violating them. Denouncing the wrongdoer undermines his reputation with others, as depicted in the third column of Figure 3. Inherent sanctions increase in effectiveness when reputational sanctions supplement them. In circumstances discussed later, reputational sanctions may succeed where inherent sanctions fail.

This section distinguished transacting, relating, and belonging. Sometimes these activities are separate from each other. For example, withdrawing money from an automated teller machine is a transaction without a relationship; romance is a relationship that may involve few transactions; and working for the Post Office may involve group membership with few relationships. More frequently, however, these activities intermingle, as when belonging to a church involves friendships that lead to business deals. When activities intermingle, more than one kind of sanction may be at work in sustaining social norms.

B. Effectiveness of Sanctions

Effective sanctions lead to successful social norms, whereas ineffective sanctions cause norms to fail. The different kinds of inherent and reputational sanctions depicted in Figure 3 succeed and fail in different situations. The analysis of these situations reveals important ways in which informal punishments fail.

Relationships that endure over time provide many opportunities for the parties to reward and punish each other. Detachment pun-

⁷⁹ See McAdams, *supra* note 17, at 1019-21.

ishes the wrongdoer by depriving him of the relationship's value. The severity of this punishment depends upon the availability of substitutes. If the relationship is unique and no substitutes exist, the punishment is severe. Conversely, if the relationship is common and close substitutes exist, the punishment is mild.

To illustrate detachment, the victim of wrongdoing may direct business away from a partner, cool a friendship, or develop interests outside a marriage. The punishment is severe if the wrongdoer has no other partners, friends, or interests, whereas the punishment is mild if the wrongdoer has many other partners, friends, or interests. The first row in Figure 4 depicts these situations.

Figure 4: Effectiveness of Sanction		
<u>activity</u>	<u>sanction</u>	<u>condition for effective sanction</u>
relate	detach	no close substitutes
transact once	denounce	stern reputation deters
belong	denounce	integration, credibility

Turning from relationships to transactions, the victim of wrongdoing in a transaction often refuses to trade or communicate with the wrongdoer in the future. Boycotting the wrongdoer punishes him by reducing his opportunities for advantageous transactions. In transactions based on relationships, a boycott by the victim sharply punishes the wrongdoer by destroying the expected value from future transactions. In one-shot transactions, however, the parties do not anticipate future dealings with each other, so a boycott by one victim hardly affects the wrongdoer. To be effective, the reputational sanctions that the few victims use must induce many people to impose inherent sanctions.

For many kinds of transactions, potential victims will heed a credible warning. In these circumstances, a potential difficulty concerns the incentives to warn. Sullyng the injurer's reputation often involves confrontation or retaliation, and consumes time and effort. The person who does the denouncing usually balances these costs against the benefit of gaining a stern reputation, which deters future injuries.

The benefits of informal punishment are partly internalized and partly externalized. The victim who denounces the injurer internalizes the benefits of a stern reputation and externalizes the benefits of the warning to other potential victims. Insofar as the victim of a transactional wrong internalizes all of the cost of denouncing the injurer and externalizes some of the benefits, victims may devote too little effort to denouncing injurers. In general, people

tend to free-ride on others' efforts to enforce social norms.⁸⁰ To overcome free-riding in enforcing transactional morality, a stern reputation must have high deterrence value, as indicated in the second row of Figure 4.

Groups provide a context for relationships and transactions, such as neighbors becoming friends and making deals. Social norms regulate these relationships and transactions. In addition, groups have their own distinctive social norms and associated punishments. I will focus on inherent values of the group, such as prestige and esteem, and consider the corresponding conditions for effective punishment. Organized groups may have formal rules and punishments. I will focus on unorganized groups with informal rules and punishments.

When a wrongdoer injures a group, the effects diffuse among its members. For example, pollution may harm a neighborhood, not merely a particular individual. Similarly, disloyalty to friends may undermine their ability to cooperate with each other. No individual in the group has much incentive to bear the risks and costs of punishing wrongs that cause diffuse harm. In general, diffuse harm undermines individual incentives to deter it, so individuals tend to free-ride on the enforcement efforts of others.

To be effective, informal enforcement of diffuse harm must be very cheap, like gossip. Denouncing a member of a group is often cheap, especially when done indirectly or confidentially. Denouncing the wrongdoer reduces his esteem and may cause others in the group to disdain him. As depicted in the last row of Figure 4, fear of disdain can deter wrongdoers who are integrated into the group, so that they desire the group's esteem. If the wrongdoers are not integrated into the group, disdain will have little deterrent power.

I explained that a group setting aggravates the problem of free-riding on informal punishments by others. Rivalry and competition partly overcome this problem. Esteem in a group can be redistributed among rivals. The person in the group who gains most from denouncing a wrongdoer is his rival. Thus, rivalry performs the useful function of overcoming the free-rider problem in informal enforcement of social norms.

Rivalry, however, aggravates another problem with informal punishment—credibility. If the injurer and the denouncer are rivals,

⁸⁰ I focus on under-enforcement by informal means, which is common. Over-enforcement, however, is also possible. Over-enforcement by informal means occurs when enforcement redirects wrongdoing without deterring it. To illustrate by analogy, if bars on the windows redirect burglars without changing the total number of burglaries, then installing bars conveys a private advantage but not a social advantage.

people may not believe the denunciation.⁸¹ In any case, overcoming the credibility problem depends on the neutrality of the speaker, or on the observability of the alleged facts.

The problem of free-riding and credibility with respect to informal enforcement provides an incentive for groups to organize. Organizational structure can ameliorate these problems. For example, an organization may have procedures for censoring or expelling members. Procedures improve credibility and broadcast denunciations more widely.

C. Four Types of Normative Failure

Figure 4 depicts conditions for the effectiveness of informal punishments. To develop a theory of legal order built on social order, I want to move from "effectiveness" to "perfection." In the study of markets, "efficiency" for economists means either Pareto efficiency or cost-benefit efficiency.⁸² I adopt the same meanings of perfection in the study of social norms. Social norms are "perfect" when law cannot improve upon them relative to these standards of efficiency. When social norms are perfect, enacting a law creates an inefficiency.

The problem the normative failure theory of law faces is to specify conditions under which the structure of social interaction results in perfect social norms. The model of morality developed above is the beginning of such a theory. As explained, typical conditions for normative perfection include a uniform signaling equilibrium and a punishment-induced equilibrium. The uniform signal must provide optimal precision and clarity about what people ought to do. Clarity and precision are optimal when no improvement can be made in communicating the obligatory act. In addition, the social norm must have a punishment-induced equilibrium with an efficient level of deterrence. I have discussed in detail the conditions for effective punishment. Perfection goes beyond effectiveness, to the point where the state cannot improve upon the level of deterrence that informal means achieve.

Although this Article cannot develop a complete account of perfect social norms, the preceding analysis suggests some salient conditions for perfect informal sanctions. I will now discuss these conditions for relationships, transactions, and groups.

⁸¹ Psychologists have investigated various perceptual distortions. To illustrate, more than 50% of drivers consider themselves to be above average. See Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 216 (1995); Jeffrey J. Rachlinski, *Gains, Losses, and the Psychology of Litigation*, 70 S. CAL. L. REV. 113, 118 (1996). Apparently, psychologists have not investigated distortions in how people perceive their rivals.

⁸² See Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509 (1980).

A relationship is "perfect" if the parties cooperate fully and maximize joint value, without harming outsiders. Research in game theory shows that a relationship tends towards this kind of perfection when the parties expect it to persist. The potential advantage from the persistence of a relationship is large when its joint value exceeds the amount available in the next best alternative to the relationship. The absence of substitutes gives the parties a strong reason to sustain the relationship. Equivalently, the parties pay a sharp price for ending a relationship that lacks close substitutes.

This analysis suggests a diagnosis for failed relationships. Relationships fail because close substitutes erode the power to punish wrongdoing. The availability of close substitutes prevents the parties from solving agency problems through strategies such as "tit-for-tat."⁸³ To restore perfection, the parties must strengthen their commitment to each other, thus making substitution harder. The parties commit by making relation-specific investments, which are more valuable inside the relationship than outside it.

An unobtrusive public policy to avoid failed relationships might promote relation-specific investment, as depicted in the first row of Figure 5. To illustrate, the agent's duties owed to the principal may be too vague and contingent to specify in their contract. In this circumstance, the law may impose a "duty of loyalty" upon the agent. Loyalty concerns moral obligations, not precise duties.⁸⁴ The duty of loyalty requires a commitment by the agent to the principal, which raises barriers against exit. Thus, the duty of loyalty promotes relation-specific investment.

Similarly, a buyer and a seller may need to make specialized investments in reliance upon each other. If cost variability precludes them from making a long-run contract with definite terms, the parties may want to commit to an enduring relationship with indefinite terms. To facilitate commitment, the parties may create a contract requiring the courts to impose sanctions on either party who undermines the relationship by, say, refusing to negotiate in good faith or dealing with a third-party competitor.

Another example comes from labor mobility in Japan. Executives change companies in Japan less often than in other countries, in part because the workers reject leaders coming over from other companies.⁸⁵ The high cost of exiting the firm apparently precludes substi-

⁸³ For an explanation of tit-for-tat in game theory, see AXELROD, *supra* note 10, at 13-14.

⁸⁴ See Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1053-56 (1991).

⁸⁵ The specific mechanisms of this argument are described in Michael Hechter & Satoshi Kanazawa, *Group Solidarity and Social Order in Japan*, 5 J. THEORETICAL POL. 455 (1993). For cautions against making sweeping generalizations based on the data, see

tuting one set of relationships for another. The absence of substitutes enhances the power of informal norms to induce cooperation without using formal contracts.⁸⁶

Figure 5: Diagnosing Failed Sanctions		
<u>Sanction</u>	<u>Cause of Sanction's Failure</u>	<u>Remedy</u>
boycott	close substitutes	relationship specific investment raise exit costs
denounce	insufficient broadcast	stigmatize
disdain	alienation	socialize
disdain	costly confrontation	focal point for solidarity

Now I turn from relationships to transactions. As with relationships, a transaction is "perfect" if the parties maximize joint value without harming outsiders. In imperfect transactions, one party destroys joint value in order to redistribute value to himself. Social norms constrain acts that destroy joint value. As discussed above, informal enforcement of transactional norms relies upon reputational sanctions. To make wrongdoing unprofitable, the victim of transactional wrongdoing must warn others against the injurer. Thus, a salient condition for perfect enforcement is full broadcast of information about wrongdoing.

This analysis suggests a diagnosis for failed transactions. The victims of wrongdoing broadcast the information in order to acquire a stern reputation. Acquiring a stern reputation can deter future wrongs. Therefore, the victim balances broadcast costs against the value of a stern reputation. Informal punishment of transactional wrongs fails when broadcasting costs too much relative to the value of a stern reputation. One remedy is to lower the cost of stigmatizing wrongdoers, as depicted in the second row of Figure 5.

To illustrate, local newspapers sometimes publish the names of persons convicted of drunk driving. Daniel Kahan has proposed systematic shaming of criminals.⁸⁷ Another illustration comes from employment practices. An employer who discharges an unsatisfactory employee and refuses to give the person a reference for another job will acquire a stern reputation. A stern reputation discourages

KAZUO KOIKE, UNDERSTANDING INDUSTRIAL RELATIONS IN MODERN JAPAN 266-67 (Mary Saso trans., 1988).

⁸⁶ See generally Hiroshi Wagatsuma & Arthur Rosett, *Cultural Attitudes Towards Contract Law: Japan and the United States Compared*, 2 UCLA PAC. BASIN L.J. 76 (1983) (describing Japanese informal contracts).

⁸⁷ See Dan M. Kahan, *What Do Alternative Sanctions Mean?*, 63 U. CHI. L. REV. 591, 631-34 (1996).

unsatisfactory workers from seeking employment with the employer. Recently, however, American companies have sometimes rid themselves of unsatisfactory employees by providing a good (but false) reference in exchange for the employee's resignation, thus escaping a suit for wrongful discharge.⁸⁸ Inaccurate references aggravate the problems of information that undermine social norms and afflict labor markets.⁸⁹

Now I turn from transactions to groups. I will focus on how groups use norms to control the supply of public goods and bads. As with relationships and transactions, a group is "perfect" in the relevant sense if the parties maximize joint value without harming outsiders. Specifically, a perfect group induces an efficient supply of public goods and bads. To achieve this end, the group must reach a consensus concerning the obligations of individuals with respect to public goods and bads, and then enforce those obligations. I will discuss enforcement but not consensus formation.

Members of a group suffer disdain and enjoy esteem from others. Besides detaching and boycotting, groups can enforce obligations by modulating disdain and esteem. Specifically, the people who observe wrongdoing can broadcast the facts, thus lowering the injurer's esteem in the eyes of the group. This suggests that a perfect informal group controls public goods and bads through esteem-modulating norms. Conversely, an informal group fails when it cannot enforce its norms by modulating esteem.

Disdain cannot deter alienated group members, who care little about the group's judgments. Social control can break down because disdain fails to deter wrongdoers. Better socialization reduces alienation, which restores the sting of disdain, as described in the third row of Figure 5. To illustrate, better integration of alienated youth into society combats street crime by making youth more responsive to social judgments.

From the group's standpoint, the ideal modulation of disdain and esteem motivates the efficient supply of public goods and bads. Unfortunately, the economic analysis of the optimal allocation of disdain and esteem is underdeveloped. No one has formulated the

⁸⁸ For an analysis of the emergence of the tort of wrongful discharge, see John J. Donohue III & Peter Siegelman, *The Changing Nature of Employment Discrimination Litigation*, 43 STAN. L. REV. 983, 983-1000 (1991); see also John J. Donohue III, *Further Thoughts on Unemployment Discrimination Legislation: A Reply to Judge Posner*, 136 U. PA. L. REV. 523 (1987) (addressing criticism of Title VII); John J. Donohue III, *Prohibiting Sex Discrimination in the Workplace: An Economic Perspective*, 56 U. CHI. L. REV. 1337 (1989) (discussing the desirability of antidiscrimination laws).

⁸⁹ See, e.g., *Doe v. Methacton Sch. Dist.*, 880 F. Supp. 380, 383-85 (E.D. Pa. 1995) (refusing to grant summary judgment to a school district that allowed a teacher who had sexually molested a student to resign and gave a "satisfactory" reference to his future employer), *modified*, 914 F. Supp. 101, 103 (E.D. Pa. 1996).

general conditions under which a spontaneous, informal assignment of esteem will be better than a more formal, explicit assignment.⁹⁰

To appreciate the problem, consider honors and awards. For example, Britain acknowledges greatness by awarding peerages, which many Englishmen apparently value more than wealth. Similarly, many corporations try to motivate workers by designating the "best employee of the month." Formal honors and prizes clearly distinguish between winners and losers. Economists, however, have not formulated the conditions under which formal honors and prizes improve upon the motivation that an informal system of esteem creates.

Competition for esteem creates another problem for informal punishment—credibility. I already discussed the credibility problem that occurs when someone denounces a rival. Forming an organization in order to provide some guarantee of objectivity can address this problem. To illustrate, diamond exchanges organize their members and police their transactions. When a merchant court finds that one member has cheated another, the wrongdoer may be excluded from the exchange and his picture may be posted in exchanges throughout the world.⁹¹ The merchant court's fact-finding process creates credibility, and posting the wrongdoer's picture facilitates a boycott.

Diffusion of the benefits and costs of public goods and bads aggravates the problem of free-riding on the enforcement of consensus obligations. Informal enforcement often risks a costly confrontation, but this risk falls dramatically when an entire group joins in the denunciation. Solidarity reduces the individual's cost of enforcement. Solidarity requires coordinating the expectations of the norm's enforcers. Coordination of expectations can occur through a focal point, as described in the fourth row of Figure 5.

To illustrate a legal focal point, the City of Berkeley recently enacted an ordinance requiring owners to clean up after their dogs (a "pooper-scooper" law). Enactment of the law clarified vague social norms concerning courtesy and signaled majority support for enforcement. After the law was passed, people became more aggressive toward discourteous dog owners. Apparently it is easier to say, "Obey the law" than to say, "Don't be so rude." Similarly, in the

⁹⁰ The rudimentary level of thought was chronicled in an exchange on the economics of prizes that occurred during the winter of 1996 on the George Mason Law and Economics e-mail bulletin board. A recent book argues that giving prizes for relative performance creates incentives for excessive work, thus turning jobs into rat races. See ROBERT H. FRANK & PHILIP J. COOK, *THE WINNER-TAKE-ALL SOCIETY* 7-11 (1995). A recent article has analyzed racial discrimination as the natural outcome of groups seeking to benefit from the organization of status. See McAdams, *supra* note 17.

⁹¹ See Bernstein, *Diamond Industry*, *supra* note 14, at 126-28, 149-50.

recent past, Americans smoked at will in many public buildings, and nonsmokers seldom complained. After most local governments enacted ordinances prohibiting smoking in public buildings, officials posted "no smoking" signs, but almost never enforced the prohibitions. Perhaps the officials believed, correctly, that other nonsmokers would complain to smokers. Enacting the ordinances apparently tipped the balance in favor of private enforcement of the social norm.

The "pooper-scooper" and "no-smoking" examples can be analyzed in terms of multiple equilibria and tipping points.⁹² In general, interdependency in enforcement costs creates an instability that causes enforcement to jump from low to high levels, or vice versa. Under certain conditions, if most citizens believe that most other citizens will enforce the social norm, then the system will move to the stable internal equilibrium with a high level of enforcement. The mere enactment of a law can dramatically reduce the cost of confrontation to an individual who enforces the underlying obligation. Conversely, if most citizens believe that few other citizens will enforce the social norm, then the system will move to the stable corner equilibrium with a low level of enforcement. In such a social system, state enactment can sometimes tip society into conformity with the law merely by causing citizens to believe correctly that most of them will enforce it.

My analysis has focused upon failures of informal punishment. Now I will briefly mention some other problems that arise when groups interact with each other—monopoly and group externality. Within a group, social norms may arise that benefit its members at the expense of nonmembers. These social norms generate a consensus within the group of beneficiaries, but not within the group of victims. Groups often create norms that benefit their members by reducing competition with people outside the group. Norms that suppress competition create a kind of social cartel. These social cartels are subject to the same analysis as economic cartels. Like business cartels, social cartels suffer from inherent instability, which lawmakers can exploit.

To illustrate, consider the problem of discrimination in labor markets. Discriminatory norms typically involve behavior by social groups resembling rules that regulate dealing among members of business cartels. As with all cartels, a person belonging to a group of discriminators often gains an advantage by breaking the norm without detection. This advantage consists of the opportunity to transact more broadly, rather than being restricted to certain transactions

⁹² See Cooter, *Decentralized Law*, *supra* note 38, at 1669-75.

among group members. The law can destabilize discriminatory cartels by protecting from the group's punishment those members who "cheat" by violating the group norms requiring discrimination.⁹³

The final form of normative failure occurs when a group permits its members to externalize costs on outsiders. For example, a village located upstream from other villages may permit its members to pollute at points below the village, thus imposing pollution on downstream villages. In effect, the social norm says, "You may not pollute upstream from our village, but you may pollute downstream from our village." This case involves a spillover.

I have explained at length that social norms arise within a group to control the harm that one person can cause to another. Consensus social norms, however, are less likely to evolve to regulate interactions between groups. This is an area where critical morality can play an important role. Another mechanism economists stress is bargaining. Applied to relations among groups, the Coase Theorem asserts that bargaining will solve spillovers, provided that transaction costs do not excessively burden bargaining.⁹⁴ A remedy for spillovers is lowering the transaction cost of bargaining between groups. Reduction in transaction costs requires organization and representation.

SUMMARY AND CONCLUSION

Law often grows from social norms that create order from consensus obligations. I model a consensus obligation as a uniform signal, and I measure the effect of a consensus obligation by a change in equilibrium behavior. Individuals committed to one moral norm often compete with uncommitted individuals or with individuals committed to a different morality. Models of morality explain how moral commitment can persist in competition with noncommitment. Inefficient equilibria indicate failures in the system of norms. Characterizing failures guides and justifies the making of law.

In a democracy, justifications for coercive law are usually grounded in the majorities' power to legitimize. The theory this Article develops, however, provides a nonmajoritarian justification of law. Instead of using majorities, this theory justifies law by consensus. This consensus concerns obligations embedded in social norms. Normative failure theory identifies the causes of failure in social norms, where "failure" refers to inefficiency as measured by the Pareto standard or the cost-benefit standard. When social norms fail, the state can sometimes improve upon the situation. Normative failure theory

⁹³ See generally Robert Cooter, *Market Affirmative Action*, 31 SAN DIEGO L. REV. 133 (1994) (arguing that state antidiscrimination laws and protections undermine discriminatory cartels).

⁹⁴ Coase, *supra* note 20, at 15.

identifies effective means of state intervention. Notice that none of the remedies proposed in Figure 5 involves state coercion. Instead, the remedies require strengthening informal norms.

Consensus can solve some persistent problems in political theory. For example, consensus represents something like actual consent, rather than the hypothetical consent that figures prominently in contractarian theories such as Rawls's *Theory of Justice*.⁹⁵ A problem that plagues majority rule is intransitivity, as Arrow's impossibility theorem demonstrates so forcefully.⁹⁶ Consensus, however, does not suffer from the paradoxes of majority rule. Social norms based on consensus reveal order, not incoherence.

Normative failure theory also has practical implications for law-making, notably in the business law context. In a competitive economy with relatively free trade, business will tend to develop efficient norms to regulate private interactions. In these circumstances, the role of state law can be limited to correcting failures in the market for norms. Failures tend to occur because private, informal punishment insufficiently deters wrongdoing. In these circumstances, state enforcement of social norms can increase private cooperation and production.

According to Locke, the state can provide more certain and secure enforcement.⁹⁷ State enforcement is more certain because a written law provides a canonical formulation of the underlying obligation and, in an ideal situation, courts apply the rule with impartiality. Additionally, state enforcement is more secure because of the state's monopoly on official use of force.

In reality, private enforcement and state enforcement typically complement each other. By cooperating with officials, citizens lower the cost and increase the effectiveness of state enforcement. Conversely, the effectiveness of private enforcement increases, and its risks to private enforcers decrease, when state officials support and supplement private enforcers. Successful state enforcement typically requires a close alignment of law with morality, so state officials enjoy informal support from private persons.

⁹⁵ JOHN RAWLS, *A THEORY OF JUSTICE* (1971).

⁹⁶ KENNETH J. ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* 46-60 (2d ed. 1963).

⁹⁷ JOHN LOCKE, *THE SECOND TREATISE OF CIVIL GOVERNMENT* 63-64 (J.W. Gough ed., 3d ed. 1966) (1690).