

Economics & Real People

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Behavioral Law and Economics is the title of a new book edited by Cass Sunstein (Cambridge University Press 2000), and it is as good a name as any for the hybrid discipline of which Sunstein is a leading theoretician and proponent. Getting a grip on the subject is no easy matter, requiring as it does a combination of law, economics, psychology, management and organizational behavior, and philosophy to create “an accurate, rather than false and stylized, sense of what people are really like” that “can be described, used, and sometimes even modeled.” This ambition makes the none-too-timid predictive claims of conventional law and economics seem wimpy. For readers who would rather start small, Sunstein’s introduction to his new book provides a pretty good little capsule of behavioral law and economics. What follows is a version of that introduction, tailored for the *Green Bag*.

– The Editors

HOW DOES LAW actually affect people? What do people do in response to the law? Why is the law as it is? How can law be enlisted to improve people’s lives? What do people like, and what *are* they like?

In the last two decades, social scientists have learned a lot about how people actually make decisions. Much of this work requires qualifications of rational choice models, which have dominated the social sciences, including the economic analysis of law. Those models are often wrong in the simple sense that they give inaccurate predictions about what people

will actually do. People are not always “rational” in the sense that economists suppose. But it does not follow that people’s behavior is unpredictable, systematically irrational, random, rule-free, or elusive to social scientists. On the contrary, the qualifications can be described, used, and sometimes even modeled. We know, for example, that people dislike losses, even more than they like gains; that they are averse to extremes; that they have a difficult time in translating many harms into dollar amounts; that they care about fairness, like to be fair, and are willing to punish unfair-

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ness; that they tend to be unrealistically optimistic; that their own moral judgments are self-serving; and that they rely on heuristics, or rules of thumb, that can lead to systematic errors.

What is most exciting about the resulting work is that it allows people to do economics, and even law and economics, with an accurate, rather than false and stylized, sense of what people are really like. My purpose in this little essay is to say something about a newly emerging field: behavioral law and economics.

PREFERENCES ARE MADE, NOT FOUND

When people make decisions, context often matters a lot. This is true for jurors asked to award punitive damages, companies confronted with tort law, and employees thinking whether to ask for leave to take care of their children. People do not walk around with “preference menus” in their heads. The surrounding environment can move them in one direction rather than another. “[O]bserved preferences are not simply read off some master list; they are actually constructed during the elicitation process. ... Different elicitation procedures highlight different aspects of options and suggest alternative heuristics, which give rise to inconsistent responses.”¹ Our preferences are often a product of procedure, description, and context at the time of choice.

Analysis of law should be linked with what we have been learning about human behavior and choice. After all, the legal system is routinely in the business of constructing procedures, descriptions, and contexts for choice. Most obviously, the legal system creates procedures, descriptions, and contexts in the course of litigated cases. For example, the alternatives (selected to be) placed before a jury or judge

may matter a great deal. Liability or conviction on some count A may very much depend on the nature of counts B, C, and D. In this respect the preferences and values of judges and juries can be constructed, not elicited, by the legal system.

Certainly this is true for the award of damages, where special problems may arise; we now know that other things being equal, juries will award more money to plaintiffs who have asked for very large sums of money. But similar points hold outside of the courtroom. The legal system’s original allocation of legal entitlements (what are the default rules in employment and consumer law?), and the structures created for exchange (or nonexchange) by law, may well affect people’s preferences and values. Thus law can construct rather than elicit preferences internally, by affecting what goes on in court, and externally, by affecting what happens in ordinary transactions, market and nonmarket.

HEURISTICS & BIASES

It is now well-established, mostly through the pioneering work of psychologists Daniel Kahneman and Amos Tversky, that people make decisions on the basis of heuristic devices, or rules of thumb, that may work well in many cases but that also lead to systematic errors. It is also well established that people suffer from various biases and aversions that can lead to inaccurate perceptions. Here is a very brief description of several biases and heuristics of particular relevance to law.

Biases

Extremeness aversion. People usually don’t like extremes. (Hence the term “extremist” is never a compliment.) As every law teacher, used car salesman, and real estate agent knows,

¹ Tversky et al., *Contingent Weighting in Judgment and Choice*, 95 *Psych. Rev.* 371, 371 (1988).

whether an option is extreme depends on the stated alternatives. In this way people can be manipulated by changing those alternatives. Extremeness aversion gives rise to *compromise effects*. As between given alternatives, most people, most of the time, seek a compromise. Almost everyone has had the experience of switching to (say) the second most expensive item on some menu of options, and of doing so partly because of the presence of the very most expensive item. In this as in other respects, the framing of choice matters; the introduction of (unchosen, apparently irrelevant) alternatives into the frame can alter the outcome.

When, for example, people are choosing between some small radio A and a mid-size radio B, most may well choose A. But the introduction of a third, large radio C is likely to lead many people to choose B instead. Contrary to economic theory, the introduction of a third, unchosen (and in that sense irrelevant) option may well produce a switch in choice as between two options. Extremeness aversion thus suggests that one of the simplest axioms of conventional economics – involving the irrelevance of added, unchosen alternatives – is wrong.

Extremeness aversion also has large consequences for legal advocacy and judgment, as well as for predictions about the effects of law. How can a preferred option best be framed as the “compromise” choice? When should a lawyer argue in the alternative, and what kinds of alternative arguments are most effective? This should be a central question for advocates to answer. Juries and judges may well try to choose a compromise solution, and what “codes” as the compromise solution depends on what alternatives are made available. And in elections, medical interventions, and policy-

making, compromise effects may matter a great deal.

Hindsight bias. According to a familiar cliché, hindsight has 20–20 vision. The cliché turns out to hold an important truth, one with considerable relevance to law. A great deal of evidence suggests that people often think, in hindsight, that things that happened were inevitable, or nearly so. The resulting “hindsight bias” can much distort legal judgment if, for example, juries end up thinking that an accident that occurred would inevitably have occurred. Judgments about whether someone was negligent will inevitably be affected by this bias.

Optimistic bias. Human beings tend to be optimistic. In fact the only group of people who have an accurate sense of their abilities, and of what other people think of them, appear to be the clinically depressed. By itself our capacity for optimism seems to be good news – a lifetime 50% shooter, Michael Jordan has been heard to say that he always believed his shots would go in, and this belief probably helped him get as high as 50%.

But unrealistic optimism can lead us to make big mistakes. Even factually informed people tend to think that risks are less likely to materialize for themselves than for others. In some contexts, there is systematic overconfidence in risk judgments, as the vast majority of people believe that they are less likely than other people to be subject to automobile accidents, infection from AIDS, heart attacks, asthma, and many other health risks.² Reflecting illusions about their own practices, gay men appear systematically to underestimate the chance that they will get AIDS, even though they do not lack information about AIDS risks in general.³ Even smokers appear to believe that they are less

² See Weinstein, *Optimistic Biases About Personal Risks*, 246 *Science* 1232 (1989).

³ Bauman & Siegel, *Misperception Among Gay Men of the Risk for AIDS Associated with Their Sexual Behavior*, 17 *J. Applied Social Psych.* 329 (1987).

likely than most nonsmokers to get heart disease and lung cancer.

Unrealistic optimism creates a distinctive problem for conventional objections to paternalism in law. If people tend to believe that they are relatively free from risks, they may lack accurate information even if they know statistical facts. Should the law be more paternalistic? This isn't clear. But to the extent that people suffer from unrealistic optimism, it is reasonable to worry that there is a real problem for law and policy, and perhaps to suggest correctives. We can see, for example, why the slogan, "Drive defensively; watch out for the other guy," is exceedingly clever – as a way of overcoming unrealistic optimism.

Heuristics

Behavioral economists and cognitive psychologists have uncovered a wide array of heuristic devices that people use to simplify their tasks; now let us turn to several of these.

Availability. People tend to think that risks are more serious when an incident is readily called to mind or "available." Hence some people think that the problem of AIDS is hugely overstated, whereas other people think that it is extremely pervasive. Because everyone's experience is limited, the availability heuristic will produce systematic errors. Assessments of risk can be pervasively biased, in the sense that people often think, wrongly, that some risks (of a nuclear accident, for example) are high, whereas others (of a stroke, for example) are relatively low. The availability heuristic greatly affects the demand for law. When people have heard of a recent problem, they are going to demand a legal response, even if the problem is trivial. In the aftermath of a highly visible incident (for example, a race crime or an environmental hazard), the legal system is likely to be

asked to intervene, whether or not the intervention will do more good than harm. And if incidents are not visible, the legal system may end up doing far too little.

Anchoring. Often people make probability judgments on the basis of an initial value, or "anchor," for which they make insufficient adjustments.⁴ The initial value may have an arbitrary or irrational source. When this is so, the probability assessment may go badly wrong. Jury judgments about damage awards, for example, are likely to be based on an anchor, such as the plaintiff's demand; this can produce a high level of arbitrariness.

Case-based decisions. Because it is often difficult to calculate the expected costs and benefits of alternatives, people often simplify their burdens by reasoning from past cases,⁵ and by taking small, reversible steps. This form of "case-based decision" plays an important role in courts, which tend to think analogically.

VALUATION

How do people react to gains and to losses? The legal system frequently deals with dollars; can people think well about dollars? What are the characteristics of their thinking?

Loss aversion. People are especially unhappy about losses. They like to keep what they have. In fact they are more displeased with losses than they are pleased with equivalent gains – roughly speaking, twice as displeased. Contrary to a central claim in economic theory, people do not treat out-of-pocket costs and opportunity costs as if they were equivalent.

Loss aversion has important implications for positive analysis of law. It means, for example, that the foundation of law and economics – the Coase theorem – is in one respect quite

⁴ See Kahneman & Tversky, Judgment Under Uncertainty: Heuristics and Biases, in Judgment Under Uncertainty 3 (1982).

⁵ See Gilboa & Schmeidler, Case-Based Decision Theory, 110 Q. J. Econ. 605 (1995).

wrong. Recall that the Coase theorem proposes that when transaction costs are zero, the allocation of the initial entitlement will not matter, in the sense that it will not affect the ultimate state of the world, which will come from voluntary bargaining. The theorem is wrong because the allocation of the legal entitlement may well matter, for those who are initially allocated an entitlement are likely to value it more than those without the legal entitlement. Thus workers allocated a (waivable) right to be discharged only for cause may well value that right far more than they would if employers were allocated a (tradable) right to discharge at will. Thus breathers of air may well value their (tradable) right to be free from air pollution far more than they would if polluters had been given a (tradable) right to emit polluting substances into the air. The legal entitlement creates an *endowment effect*, that is, a greater valuation stemming from the mere fact of endowment.

There is a further point. People are averse to losses, but whether an event “codes” as a loss or a gain depends not on simple facts but on a range of contextual factors, including how the event is framed. The status quo is usually the reference point, so that losses are understood as such by reference to existing distributions and practices; but it is possible to manipulate the frame so as to make a change code as a loss rather than a gain, or vice-versa. There is evidence that government can produce more change if it says, “If you fail to use energy conservation techniques, you will lose \$ x per year,” than if it says, “If you use energy conservation techniques, you will save \$ x per year”—even though these statements are actually identical. Consider a company that says “cash discount” rather than “credit card surcharge”; or a parent who says that for behavior x (rather than behavior y) a child will be

rewarded, as opposed to saying that for behavior y (rather than for behavior x) a child will be punished; or familiar advertisements to the effect that “you cannot afford not to” use a certain product. In environmental regulation, it is possible to manipulate the reference point by insisting that policymakers are trying to “restore” water or air quality to its state at time x ; the restoration time matters a great deal to people’s choices.⁶

Loss aversion also raises serious questions about the goal of the tort system. Should damages measure the amount that would restore an injured party to the status quo ante, or should they reflect the amount that an injured party would demand to be subject to the injury before the fact? Juries appear to believe that the amount that would be demanded pre-injury is far greater than the amount that would restore the status quo ante. The legal system appears generally to see the compensation question as the latter one, though it does not seem to have made this choice in any systematic way.

Mental accounting. A simple and apparently uncontroversial assumption of most economists is that money is fungible. But the assumption is false. Money comes in compartments. People create “frames” that result in mental accounts through which losses and gains, including losses and gains in simple monetary terms, are not fungible with each other. A glance at ordinary practice shows that people often organize decisions in terms of separate budgets and accounts. Thus some money is for retirement; some is for vacation; some is for college tuition; some is for mortgage or rental payments. Mental accounting is an important aspect of financial self-control, and the practice of mental accounting has a range of implications for law and policy. It suggests, for example, that government may

6 See Gregory et al., *The Role of Past States in Determining Reference Points for Policy Decisions*, 55 *Org. Behavior and Human Decision Processes* 195 (1993).

be able to create certain mental accounts by creative policymaking. And it suggests that there may be a demand for publicly created mental accounts, perhaps as a self-control strategy, as for example with Social Security and other programs with an apparent paternalistic dimension. Some statutes that appear to prevent people from making choices as they wish may be best understood as responsive to the widespread desire to have separate mental accounts. Of course there are private mechanisms for accomplishing this goal, but lawyers will not understand those mechanisms well unless they see that money itself is not fungible.

The difficulty, outside of markets, of mapping judgments onto dollars. Often the legal system requires judges or juries to make judgments of some kind and then to translate those judgments into dollar amounts. How does this translation take place? Can it be done well? In many contexts, normative judgments of a sort are both predictable and nonarbitrary.⁷ With respect to bad behavior that might produce punitive damages, for example, people come up with pretty uniform judgments on a bounded numerical scale. Similar findings have been made for environmental amenities in the context of contingent valuation. But the act of mapping those normative judgments onto an unbounded dollar scale produces considerable “noise” and arbitrariness.⁸ When people are asked how much they are willing to pay to protect 2000 birds, or how much a defendant should be punished for reckless conduct leading to personal injury, the numbers they generate really seem to be stabs in the dark – and what is done by one group of twelve people is a pretty bad predictor of what will be done by another group of twelve people.

The legal system, however, frequently relies on just those stabs. Thus the award of damages for libel, sexual harassment, and pain and suffering are infected by severe difficulties, as is the award of punitive damages in general. An understanding of those difficulties may well lead to concrete reform proposals. Perhaps the “mapping” can occur by a legislative or regulatory body that decides, in advance, on how a normative judgment made on a bounded numerical scale can be translated into dollars.

THE DEMAND FOR LAW

Why is law as it is? Behavioral law and economics provides some distinctive answers.

Cooperation, fairness, spite, and homo reciprocans. Economists sometimes assume that people are self-interested, in the sense that they are focused on their own welfare rather than that of others, and in the sense that material welfare is what most concerns them. This is sometimes true, and often it is a useful simplifying assumption. But people also may want to be treated fairly and to act fairly and, perhaps even more important, they want to be seen to act fairly, especially but not only among nonstrangers. For purposes of understanding law, what is especially important is that people may sacrifice their economic self-interest in order to be, or to appear, fair. Rather than being *homo economicus*, people may be *homo reciprocans*.⁹

Consider, for example, the ultimatum game. The people who run the game give some money, on a provisional basis, to the first of two players. The first player is instructed to offer some part of the money to the second player. If the second player accepts that

⁷ See Behavioral Law and Economics chapter 9.

⁸ See *id.*

⁹ See Fehr & Gächter, How Effective Are Trust- and Reciprocity-Based Incentives, in *Economics, Values, and Organization* 337 (Ben-Ner & Putterman eds., 1998).

amount, he can keep what is offered, and the first player gets to keep the rest. But if the second player rejects the offer, neither player gets anything. Both players are informed that these are the rules. No bargaining is allowed. Using standard assumptions about rationality, self-interest, and choice, economists predict that the first player should offer a penny and the second player should accept. But this is not what happens. Offers usually average between 30% and 40% of the total. Offers of less than 20% are often rejected. Often there is a 50–50 division. These results cut across the level of the stakes and also across diverse cultures.

The results of the ultimatum game are highly suggestive. Perhaps people will not violate norms of fairness, even when doing so is in their economic self-interest, at least if the norm-violations would be public. Do companies always raise prices when circumstances create short-term scarcity? For example, are there social constraints on price increases for snow shovels after a snowstorm, or for umbrellas during a rainstorm? It may well be that contracting parties are reluctant to take advantage of the misfortunes of another, partly because of social constraints on self-interested behavior. One of the enduring puzzles in economic theory is that employers do not cut wages during a recession; the answer appears to be that workers perceive wage cuts as unfair.¹⁰ Employers know that workers think that wage cuts are unfair, and employers are reluctant to cut wages for fear that if they do, workers will shirk. Here there is much room for future work. Experimental work shows a high degree of cooperation in social situations, especially when people are speaking with one another.

All this bears on the content of law. People often want law to be fair, and to the frustration of many economists, they will insist on fairness, sometimes, even at the expense of eco-

nomics principles. Hence the law of many states forbids “price gouging.” We are likely to be able to learn a great deal about the content of law once we untangle ordinary people’s judgments about fairness.

Self-serving bias. People care about fairness, and they want to be fair. But their (our!) judgments about fairness are self-serving, and they tend to be both unrealistically optimistic and overconfident about their judgments. In any random couple, it is highly likely that addition of answers to the question, “what percentage of the domestic work do you do?” will produce a number greater than 100%. The point bears on the otherwise largely inexplicable phenomenon of bargaining impasses. Why don’t more cases settle? Why does the legal system spend so much on dispute settlement? Part of the answer lies in the fact that self-serving bias – a belief that one deserves more than other people tend to think – affects both parties to a negotiation, and this makes agreement very difficult.

Availability again and social influences. We have seen that people make judgments about probability on the basis of judgments about available or easily retrievable instances. Moreover, the availability heuristic operates in an emphatically social environment. People often think and do what (they think) other people think and do. Partly this is because when a person lacks much personal information, he will sensibly rely on the information of others. If you don’t know whether pesticides cause cancer, or whether hazardous waste dumps are a serious social problem, you may as well follow what other people seem to think. And partly this is because of reputational influences. If most people think that hazardous waste dumps are a serious social problem, or that laws should ban hate crimes, you might go along with them, so that they do not think that you are ignorant, malevolent, or callous.

¹⁰ See Bewley, *Why Wages Don’t Fall During A Recession* (2000).

These points have a wide range of implications for the content of law. They help explain the supply of, and the demand for, government regulation. “Availability cascades” help drive law and policy in both fortunate and unfortunate directions. Consider the fact that with the Love Canal incident in the background, Americans have long ranked abandoned hazardous waste dumps among the three most serious environmental problems – even though experts do not consider the problem to be nearly that serious. Our regulatory policy, reflecting a combination of hysteria and neglect, is very much influenced by the poor priority-setting inevitably produced by availability cascades.

THE FUTURE

Behavioral law and economics is in its very early stages, and an enormous amount remains to be done. Some of the outstanding questions are foundational and involve the nature of economics itself: Can behavioral economics generate a unitary theory of behavior or is it an unruly collection of effects? Is it too ad hoc and unruly to generate predictions in the legal context? As compared with approaches based on ordinary rationality assumptions, does behavioral economics neglect the value of parsimony? In what sense is behavioral economics a form of economics at all?

Many unanswered questions are empirical, and these remain to be studied in both real-

world and experimental settings. An especially important issue has to do with the possibility of increasing cooperative behavior and decreasing spiteful behavior. What are the preconditions for the two? When does law produce one or the other? From another direction, it would be highly desirable to have a full data set of jury awards in cases involving injuries that are hard to monetize (libel, pain and suffering, sexual harassment, and intentional infliction of emotional distress), and to see what factors account for high or large awards. Whether normative judgments are widely shared, and dollar awards widely divergent, is an intriguing issue in numerous areas of the law.

A very large question involves the extent to which education can counteract cognitive and motivational distortions, so as to eliminate some of the effects described above. Is it possible for those involved in law to “debias” people, in the process, perhaps, lengthening human lives? What institutions work best at reducing the effects of biases? Would a broader understanding of behavioral economics produce learning, and thus make it less necessary to use behavioral economics? Despite the amount of work done thus far, behavioral law and economics remains in its earliest stages, and much remains to be done in promoting its basic goals – helping to produce new and improved understandings of the real-world effects of law, and ultimately better uses of law as an instrument of social ordering. 