

Efficiency vs. Ethics: Which Is the Proper Decision Criterion in Law Cases?

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Ever since economists undertook an economic analysis of the law there has waged the debate as to the proper criterion to use in deciding law cases. So far two criteria have occupied center stage: efficiency and ethics.

This paper seeks to closely examine each criterion in terms of its relationship to two legal-philosophical concepts. First, each will be examined in terms of its ability to satisfy the overall objective of the law. Second, and in a general tone, the contractual origins of each will be discussed.

Before proceeding to these main issues, however, we need to discuss four questions, first, because doing so will provide a framework with which to advance to the thesis of this paper, and, second, because the recent literature in law and economics addresses the issues contained herein. They are: (1) What is efficiency? (2) What is ethics? (3) Is what is efficient also ethical? and (4) Can there be law without ethics?

Economists, in different settings and at different times, have used the word "efficiency" in different ways. Consider a few. "Efficiency" has been used to refer to:

- 1) the allocation of resources to their highest use (as in the statement, "the marketplace is efficient");
- 2) utility maximization (e.g., "I have undertaken the efficient amount of study"—which means I have studied to the point where the marginal benefits of study equal the marginal costs of study);
- 3) the gains from trade being exhausted (e.g., "the point at which the supply curve and the demand curve intersect is an efficient position");
- 4) the "proper" means being utilized to meet a given end (e.g., "he is efficient in the sense that his objective is to lose weight and his dieting is the way to accomplish it");
- 5) a state of affairs where no change can be made without adversely affecting someone (as in, "government program X is an efficient program").

Most economists will probably recognize that these references to "efficiency" are not all definitionally different; i.e., the third reference is defini-

tionally the same as the first and fifth. In fact, a special feature of this list is that all references to efficiency are definitionally alike if costs and benefits are defined subjectively. If costs and benefits are defined objectively, then they are not.

Consider, for instance, the possible conflict of reference number 1 up against reference number 4 when costs and benefits are "measured" objectively. Here it could be the case that resources were not allocated to their highest use (reference number 1) and that therefore inefficiency reigned, but if this were the goal being sought, efficiency would be said to exist in the sense of reference number 4.

If, however, we speak in terms of subjective costs and benefits, then reference number 1 is identical to reference number 4. This is proved in a rather indirect manner. Since, in fact, we cannot prove whether or not an individual is using the "proper" means to achieve an end (because in most cases we do not know what the end is), we therefore cannot know whether resources are allocated to their highest use. All we can say with certainty is that allocation of resources to their highest use is surely sometimes an end.

It would appear, then, that under certain conditions, economists have different definitions of efficiency. This has been a point of discussion within the general topic of efficiency vs. ethics. The Austrian economists, most notably, have criticized the use of efficiency as a judicial decision criterion principally because they believe neoclassical economists have defined the term "efficient" incorrectly. To illustrate this point consider the words of a number of different Austrians.

Let us take a given individual. Since his own ends are clearly given and he acts to pursue them, surely at least his actions can be considered efficient? But no, they may not, for in order for him to act efficiently, he would have to possess perfect knowledge—perfect knowledge of the best technology, of future actions and reactions by other people, and of future natural events. But since no one can ever have perfect knowledge of the future, no one's action can be called "efficient". We live in a world of uncertainty. Efficiency is therefore a chimera.¹

I conclude that we cannot decide on public policy, tort law, rights, or liabilities on the basis of efficiencies or minimizing of costs.²

So what meaning can efficiency have? The closest it comes to being meaningful is to identify actions in which the perceived benefits exceed the perceived costs—such an action is efficient—but, of course, to the radical subjectivist who allows the actor to demonstrate his own perceived costs and benefits every action is of this nature. Unless we impose some outside, exogenous constraint that allows us to differentiate efficient from inefficient the term "efficiency" is indeed superfluous.³

The idea of efficiency is hopelessly clouded in ambiguity, and clear thinking might better be served by complete elimination of the notion.⁴

For Austrians, then, it is only when all market participants have perfect knowledge and foresight of the availability of means, that market plans will be perfectly coordinated and "perfect" efficiency will exist.⁵

It would be easy to end the matter here, and simply call into serious question the neoclassical definition of efficiency. Since efficiency, defined in the Austrian sense, is an ideal rather than a reality, it is impossible to use efficiency as a decision criterion in law cases. But since most neoclassical economists will find this route less than convincing, let us take the difficult route. For purposes of this paper, the Austrian definition of efficiency will not be used, but not all of the Austrian "insights" will be ignored.

In contrast to efficiency, ethics is difficult to define, at least in specific terms. Generally, however, ethics deals with standards of right and wrong, and principles of morality, duty and obligation. These are all high-sounding words, but they leave us with an imperfect sense of what ethics really is. Words like right and wrong, good and bad, are not amenable to social science analysis because of their ambiguity. What constitutes a right action or a wrong action? What is good? What is bad?

However, while ethics may be difficult to specifically define, this does not mean it should not be considered as a proper decision criterion in law cases. Just as unambiguous definition is no guarantee of judicial propriety, ambiguous definition is no guarantee of judicial impropriety. Individuals may have a sense of right and wrong which they cannot verbalize, but there may in fact be more agreement on their non-verbalized, loosely defined thoughts and feelings than on a verbalized, strictly defined concept.

While this could be the case (and we shall address ourselves to this matter more fully later) the idea leads us to ask an important and controversial question: To what degree, if any, is the efficiency criterion a way of verbalizing our feelings on ethics? If our ethical standards are, in essence, efficiency based, then it would appear superfluous to conduct a discussion on the merits and demerits of each since one is simply the verbalization of the other.

The idea that ethics is efficiency based is held by many of those economists who are placed in the efficiency criterion camp. Demsetz, for one, believes that the efficiency criterion has much to say, if not everything, about how we look at issues of right and wrong.

The legal rules of thumb we adopt, and even our use of such words as fault and accident seem to reflect basic efficiency considerations. Efficiency seems to be not merely one of many criteria underlying our notion of ethically correct definitions of property rights, but an extremely important one. It is difficult even to describe unambiguously any other criterion for determining what is ethical.⁶

This is neither the place nor the time to wage a full debate over whether or not ethics is wholly efficiency based. Suffice it to say that many individuals do not think that it is, and for good reasons. For many, ethics may subsume efficiency standards; but ethics is not (totally) efficiency, rather it is broader and more encompassing.

That this is so will be seen in the fact that individuals do not agree on the origin of our ethical code. For some we are born with it; i.e., we innately

"sense" what is right and wrong much as we sense "hot" and "cold". For others our ethical code is dependent upon our environment, and as our environment changes so also does our concept of what is right and wrong change.

There is also the view that our ethics are consciously taught to us. Given this our ethical code can be wholly efficiency based if, and only if, the efficiency criterion is the sole criterion on which the teaching is based. Although some economists would like to see this state of affairs, it is very doubtful that it presently exists. This is not to imply, however, that it should not.

The list of "explanations" concerned with the origin of our ethical code is seemingly endless. Ethics—principles of right and wrong—may be contracted upon, constructed, taught, propagandized and innately felt; furthermore, within each of these classifications, ethics may be as specifically or generally defined as the imagination allows.

One thing is certain: no law can long endure in a democratic setting unless it is based on some ethical code, which is to say, principles of right and wrong. As we have said, these principles may change but they are always there as the base of the law. This is because law has always had a normative content to it. It concerns what individuals should and should not do. Ethics is introduced once we make explicit the fact that what we should be doing is *right* and what we should not be doing is *wrong*.

The Objective and Characteristics of the Law

Why do we need law? The answer to the question comes by imagining a world without law. In a world without law and where individuals differ in their personalities, temperaments, and beliefs, chaos (and the resulting uncertainty) will reign supreme. Law exists because most, if not all, persons seek certainty in their lives.

There are, of course, different types of certainty. A law saying that every third child born to a family would be killed may put certainty into peoples' lives, but would be seen as causing an undesirable state of affairs. Certainty is then a necessary, but not a sufficient, condition for good law.

Besides being a stabilizing force, good law must be, or at a minimum appear to be, fair and just. Once again, these words are impossible to define specifically, and because of this "good law" is impossible to define. Instead of leaving the discussion at this point, however, let us offer a definition of good law—incorporating the concepts of justice and fairness—on which perhaps most readers can agree. (I am making the assumption that most readers of this essay will not be anti-freedom in an individualistic sense.) Let us define good law as being both certain and general (unbiased), as maximizing individual liberty and minimizing social tension.

At first sight the law would appear to be less certain with ethics as the judicial decision criterion than with efficiency, for the simple reason that efficiency can be specifically defined and ethics cannot. In a tort case, for

example, an individual will know that he will be penalized if he is the least-cost avoider of an accident. The efficiency criterion is quite clear cut. But with the ethics criterion, an individual will only know that he will be penalized if he commits a wrong. And what is "wrong" will be determined by a number of factors: legal precedent, custom, legal philosophy, and/or the political and social philosophical bent of the judge. On the surface, then, certainty of the law is more likely guaranteed by using the efficiency criterion than by using the ethics criterion. But that is so only from one perspective.

Consider that the efficiency criterion deals with costs and benefits, which are necessarily subjective. It is the subjective nature of costs and benefits which give the law an uncertain tone when the efficiency criterion is used.

When based on the efficiency criterion, law will be applied on a case-by-case basis much more so than when based on the ethics criterion, since costs and benefits are different in different cases. In other words, though there is certainty in the fact that the efficiency criterion can be easily and specifically defined, there is uncertainty in "measuring" the costs and benefits in each case.

As an example, an individual might obtain a certain amount of utility from knowing and understanding the specific and narrow criterion that will be used to decide his guilt or innocence, but still suffer a certain amount of disutility from not knowing whether his costs and benefits can be measured accurately by external observers. If the latter effect outweighs the former, then there is a net disadvantage to using the efficiency criterion as far as the certainty of the law is concerned.

Legal precedent would be of little help here. Surely judges would still rely on precedent to decide law cases, but in that past decisions were based on the efficiency criterion, the value of precedent of the law would be greatly reduced from what it is presently. Judges would be employing the same (efficiency based) "reasoning" when they looked to past cases (decided upon efficiency grounds), but this would not provide them with any insight on how better to decide on present cases. All they would know from studying past cases is that they should seek to allocate responsibilities between individuals in such a way as to maximize value. This, in and of itself, however, would not provide judges with the knowledge of exactly how to go about doing this, for they would still have the immense burden of trying to "measure" the costs and benefits for the individuals in legal dispute.

The efficiency criterion, then, removes much of the value of basing decisions on precedent. Precedent, it should be remembered, is a means by which judges speak to each other through time; it is the means by which they pass on to each other certain "insights" on the law that they might have. In that it is a link between the present and the past, it is a mechanism which gives the law certainty. Much is thus lost when the efficiency criterion occupies center stage.

Furthermore, in that the efficiency criterion increases uncertainty and

decreases the probability that "insights" will be passed from one generation to another, it also increases social tension and leads to the view that the law is not general. Once again this stems from the fact that costs and benefits are subjective. Individuals will have their own estimates of costs and benefits, which will likely differ from those of the judge. Consequently, at maximum, fifty percent of all individuals involved in a law case will feel that justice was not done since the efficiency criterion was not adequately met.

Problems are compounded by the fact that individuals who seek to have issues adjudicated are likely to have little information on how their case might be decided, even after reviewing past (similar) cases. Again this is because their perception of a similar case, and of their costs and benefits, may be entirely different from that of the judge. The subjective element makes it so. In so far as individuals do not feel they received the same treatment as did other individuals in (what are to them) similar cases, they will come to see the law as biased. This situation, by itself, would be enough to increase social tension.

The statement has been made above that, since costs and benefits are subjective, using the efficiency criterion would result in at maximum fifty percent of all individuals involved in a law case believing that they were unjustly treated. A counter question might be raised: Would this not be the case no matter what the decision criterion? Since in every law case there are two parties, and one "wins" and the other "loses," it could be argued that at maximum fifty percent of the individuals would always feel they were unfairly treated, no matter which decision criterion was used.

The ethics criterion and efficiency criterion do not necessarily call forth the same response, however. Surely using either criterion separately will create dissatisfied persons, but the question is with which will there be more dissatisfied persons. While it is difficult to prove this conclusively, the efficiency criterion will leave more dissatisfied persons than will the ethics criterion. The reason is simple: With the ethics criterion, arguments for deciding one way or the other are more numerous and objective in nature than arguments based on the efficiency criterion, and they therefore have a greater probability of being accepted by the losing side.

Consider a defendant asking his lawyer after the trial why he lost. With the efficiency criterion being used, the lawyer would say something to the effect that the judge deemed that the plaintiff, in a world of zero transaction costs, would have paid more to have this verdict than he (the defendant) would have. It is doubtful that most individuals would be so introspective as to understand the logic here; rather they would likely see the efficiency criterion as representative of justice being bought.

It would be difficult to misinterpret the ethics criterion in this same way. Here the lawyer might answer his client's question by making some reference to legal precedent, standards of accepted behavior in certain types of cases, real and unreal expectations. While the explanations will not always

be convincing they will probably be more acceptable, or less disagreeable, than those that would be used to explain the efficiency criterion. In that this is true, it tells us something about which criterion would be more likely to increase respect and support for the law.

Opportunity Costs and Contractual Considerations

The choice between efficiency and ethics as a decision criterion is a serious one. The legal framework will be substantively different with one than with the other. Before we discuss this, it is important to step back and examine the relationship between the "criterion of the marketplace" (as efficiency has been called) and the law under the two respective decision criteria.

With the efficiency criterion, we are, in fact, examining and judging the law in terms of efficiency. Here the law is subject to efficiency standards. Good law is law that is efficient, and bad law is law that is inefficient.

With the ethics criterion, efficiency does not occupy as prominent a place. Here the law is not valued in terms of efficiency, but rather, efficiency simply operates within a legal framework which is built only partly upon efficiency considerations. Good law, then, does not necessarily have to be efficient. With the efficiency criterion we have economic imperialism. With the ethics criterion, we do not. Consequently, the law would be largely different under each.

The whole matter can, perhaps, be seen more clearly in terms of opportunity cost, as James Buchanan has suggested. He writes: "Is 'maximum value' a more acceptable extralegal criterion for judicial decision than 'social justice'? The opportunity costs of introducing more sophisticated economics into legal training may be measured in the lost opportunities for attaining a better appreciation of fundamental constitutional precepts."⁷

From a slightly different perspective the question is: How should we judge the law? The law, which is used to judge us, needs first of all to be judged. This, of course, gets us into the area of constitutional contractarianism. Within a methodologically individualist framework, it is difficult to conceive of a better way to judge anything than on a contractual basis where individuals are viewed as philosophical equals. The question then becomes: Would philosophical equals in a contractual setting choose economic imperialism or not?

No one can give a definitive answer to this question. We can only make a reasonable guess as to what might occur. Asking whether philosophical equals in a contractual setting would choose economic imperialism or not is, in effect, asking whether or not they would think in terms of, and be responsive to, the opportunity costs which Buchanan noted. We should remember that choosing economic imperialism necessarily limits one. It means that efficiency is the sole criterion by which the law will be judged, and, consequently, by which individuals will be judged. Deciding against economic imperialism means that one is not hemmed in by one strict criterion with

(apparently) high opportunity costs. It therefore seems likely that at least some individuals would opt for the broad ethical measure over the narrow efficiency measure. Compromises might lead to choosing the ethical measure since it can (and does at times) subsume the efficiency criterion.

This discussion is put forth only as a reasonable hypothesis, not as truth. A conclusion of sorts, however, is that efficiency may not be the decision criterion of the market as some have suggested. Demsetz, for one, has asserted that "the criterion of efficiency assumes no more than does the criterion of the marketplace."⁸ In fact it becomes evident that the two are the same for Demsetz once we read his following statement, keeping in mind our definition of efficiency: "The market weighs and compares the beneficial and harmful effects. . . ."⁹

The great emphasis which efficiency-camp economists place on the efficiency criterion as the market criterion is somewhat misplaced and defines the market in a certain, rather narrow way. "The market" is simply a quick phrase to refer to the exchange process, a process which incorporates not only the buying and selling of goods and services for money but also the "buying" and "selling" of ideas about law. Here, contractual constitutional agreement is a *market test*, and as such, the efficiency-camp economists can no longer justifiably criticize as "anti-market" the criterion for judicial decision making (reasonably the ethics criterion) which emerges out of a contractual setting.

Conclusion

The debate between the proponents of the efficiency criterion and the ethics criterion will surely go on. Hopefully the path traveled will be one of "testing" each criterion. This paper should be seen as a first attempt at doing just that.

Besides studying the contractual origins of each, and noting the probability each has of guaranteeing the characteristics of "good law," there exist further areas that need to be explored. Perhaps each criterion should be examined as to its prospects for increasing the likelihood that judges will extend themselves beyond their constitutional task of "finding" the law into the unconstitutional area of "making" the law: Further, each should be analyzed as to its prospects for promoting or hampering economic and social progress. Rich areas of research are waiting. Far too much is at stake to sit idly by.

NOTES

1. Murray N. Rothbard, "Comment: The Myth of Efficiency," in Mario J. Rizzo, ed., *Time, Uncertainty and Disequilibrium* (Lexington, Mass.: Lexington Books, 1979), p. 90.
2. *Ibid.*, p. 95.
3. John B. Egger, "Efficiency Is Not a Substitute for Ethics," in Rizzo, *Time, Uncertainty and Disequilibrium*, p. 121.

4. Mario J. Rizzo, "Uncertainty, Subjectivity and the Economic Analysis of the Law," in *Time, Uncertainty and Disequilibrium*, p. 86.
5. Roy E. Cordato, "The Austrian Theory of Efficiency and the Role of Government," *Journal of Libertarian Studies* 4, no. 4:398.
6. Harold Demsetz, "Ethics and Efficiency in Property Rights," in Rizzo, *Time, Uncertainty and Disequilibrium*, p. 109.
7. James M. Buchanan, *Freedom in Constitutional Contract: Perspectives of a Political Scientist* (College Station, Tex.: Texas A & M University Press, 1977), p. 49.
8. Harold Demsetz, "Ethics and Efficiency in Property Rights," p. 104.
9. *Ibid.*, p. 105.