

Law and Preferences

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Legal rules do more than provide incentives, they change people. When preferences and norms are endogenously determined via a process of imitation and learning, legal rules, by affecting the market outcome, may affect the dynamics of preference formation. Analyzing the effect of different legal rules should therefore go beyond the analysis of the incentives they provide. It should also include an analysis of their effect on the distribution of preferences and norms of behavior. We illustrate this claim by considering a simple market game in which individuals may have preferences that include fairness concerns. We show that different legal rules change not only the pattern of trade in a market game, but also individuals' fairness concerns. That is, different rules may eventually make individuals care more (or less) about a fair outcome. Specifically, our model suggests that enhanced remedies for breach of contract may reduce equilibrium preferences for fairness.

1. Introduction

The economic analysis of law adopts the view that legal rules are incentive mechanisms (see, e.g., Posner, 2003; Shavell, 2004). They influence individual behavior by shaping the payoff structure associated with alternative courses of action. In this article we argue that the legal system does more than provide incentives; it also affects the preference profile in the population.¹

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1. In its focus on incentive effects, taking preferences as given or exogenous, the economic analysis of law has followed a basic tenet of neo-classical economics. See, for example, Becker (1976): "all human behavior can be viewed as involving participants who maximize their utility from a stable set of preferences . . .," and Stigler and Becker (1977). While neo-classical economics traditionally assumes that preferences are exogenous, economists have long recognized the malleability of individual preferences. See, for example, Schoeffler (1952), Harsanyi (1953–1954), Sen (1995) and Bowles (1998).

That is, different legal systems may affect not just the behavior of individuals, but who they are. And since who you are also affects how you choose to behave, a new indirect influence on behavior is introduced. Such an approach expands the boundaries of law and economics, introducing the endogenous formation of preferences as part of the analysis.

Lawyers, philosophers, and psychologists have long recognized the role of law in shaping norms and preferences. Speaking more generally on government, John Stuart Mill argued that “government itself should be evaluated in large measure by its effects on the character of the citizenry” (cited in Sunstein, 1997:27; see also Bar-Gill and Fershtman, forthcoming). Focusing on legal policy, traditionally criminal law has been understood as a means of shaping preferences and instilling morality. Jeremy Bentham (1789:339) noted that:

A punishment may be said to be calculated to answer the purpose of a moral lesson, when, by reason of the ignominy it stamps upon the offence, it is calculated to inspire the public with sentiments of aversion towards those pernicious habits and dispositions with which the offense appears to be connected; and thereby to inculcate the opposite beneficial habits and dispositions.

(See also Andenaes, 1952, 1966, 1971; Aronson and Carlsmith, 1963; Hawkins, 1969; Hampton, 1984; Dau-Schmidt, 1990; Rychlak, 1990; Kahan, 1996.)

The understanding that law influences norms and preferences is not confined to the criminal justice arena. Summarizing the literature, Kaplow and Shavell (2002:415) observed: “The suggestion is often made that, if the law symbolically denounces some preferences or reinforces others by appearing to embody certain viewpoints, individuals will come to adopt different preferences and, in turn, to behave differently” (see also Kornhauser, 1989:42–49; Sunstein, 1997). More recently, the literature on law and social norms has stressed the influence of legal rules on norms and preferences (see, e.g., Huang and Wu, 1994; Sunstein, 1996; Cooter, 1998, 2000).

The broad writing on the influence of legal policy on norms and preferences has largely been founded on the symbolic or expressive impact of law. If the law says that x is “bad” (or illegal), then preferences will ultimately adjust to devalue x ; and conversely, if the law says that x is “good,” then preferences will adjust to value x (see, e.g., Cooter, 1998; Kaplow and Shavell, 2002).

Building on recent developments in economic theory and evolutionary game theory (specifically on the indirect evolutionary approach initiated by Guth and Yaari, 1992), we introduce a different mechanism through which law influences the formation of preferences. Following traditional law and economics, we focus on the incentive effects, rather than on the

expressive effects, of the law. The law defines the payoffs associated with various choices that people make. But choices also depend on preferences. For any given payoff matrix, as established by the legal system, different people with different preferences will generally choose different courses of action. And, certain people, with certain preferences, will do better (in material terms, for instance) than other people with different preferences. Assuming that learning, imitation, and other forms of cultural transmission shift the preference profile in a given society toward more successful preferences, the link between law and preferences is established.

We propose this payoff-based model of the interaction between law and preferences as an alternative to the expressive law model. Of importance is that the two models are not mutually exclusive. In particular, there are contexts where the legal regime may affect norms and preferences both through an expressive channel and through a payoff-based evolutionary channel. For example, antidiscrimination laws likely work through both channels. On the other hand, there are contexts where the legal rule can affect norms and preferences, through the payoff-based evolutionary channel, without having any apparent expressive content. In the example studied below, the preference change brought about by the legal rule, operating through the payoff-based evolutionary channel, cannot be explained on expressive grounds.

To illustrate the proposed approach, we consider a common scenario. A seller and a buyer negotiate the price of a product. After the contract is signed, an “unforeseen” event may occur raising the seller’s cost of performance. Given such an event, the seller may ask to renegotiate the contract. The threat point in such renegotiation is determined by the legal rule that specifies the legal remedy in case no agreement is reached in the renegotiation phase and the seller decides to breach the contract. The standard law and economics approach considers the incentive effects of different legal rules on the outcome of the renegotiation process and on the seller’s decision whether to perform or rather breach the contract.

Into this framework we introduce preferences for fairness. We allow for the possibility that individuals wish to be treated fairly, and that they experience disutility whenever they are not so treated. These fairness concerns will affect the market outcome, that is, the original contract price and the seller’s ability to extract a modification in the renegotiation stage as well as the magnitude of any agreed upon price modification.

In particular, fairness concerns reinforce a party’s bargaining position when negotiating the initial contract price, thus providing for a more favorable price. At the renegotiation stage, fairness concerns mostly affect the seller’s bargaining position. On the one hand, preferences for fairness may bolster the credibility of the seller’s threat to breach, thus enabling the seller to extract modifications that would otherwise be impossible to obtain. On the other hand, an excessive fairness concern might lead the

