1. Law’s Performance

Mediate upon these things; give thyself wholly to them: that thy profiting may appear to all.

The Bible. NT 1 Timothy 4:15

The market has its own set of values and norms and is interdependent with the values and the institutions of the law. Markets are legal constructs, they provide ‘solutions to the problems of property rights, governance structures, conceptions of control and rules of exchange (Ardalan, 2007, pp 949). With that we concur. A political economy of law paradigm does not search for general results that can be transformed into a norm or standard rather it searches for time patterns that develop within a market system in which equilibrium may or may not occur. It differentiates between the law that is established in society through norms and standards at time period t, and the law that is observed, through individual interaction and experience of the law, at time period t + T. The time interval allows individuals to act and to respond.

Rational choice is an important concept in providing an economic analysis of law. But economists are examining the epistemology of economics at a time when its mathematically deductive method is less appropriate in explaining social phenomenon. Colander (2000) points out that economics is moving away from deductive principles as economists start to believe that more complex analysis is the appropriate domain for economics. Rational choice has dominated legal reasoning across tort, contract and antitrust law. However, in practical terms the rational choice model is limited in the application of the law, which is complex, unpredictable and fundamentally uncertain.

INTRODUCTION

Law cannot be understood unless we put law in context by understanding the socio-psychological and organisational factors at play in the promulgation of the law. There is no definitive ground so a fact-finder has to ask: what is its ground? We refer to this ground or environment as x-law throughout the book, to capture some element of the complexity and behavioural characteristics of
the many actors who perform law. It is the environment wherein law is experienced. It is an environment where the probability of conviction, for example, may have as much to do with the language of the law, legal reasoning and jury selection as it has to do with the facts of the case.

As individuals we act out of duty. As individuals most of us act out of respect for others. Others observe our actions. The law intervenes, but does it remain secondary in relation to our purely legal behaviour of conformity to the law? Conformity to the law can be challenged by the fact-finder who declares ‘tell me what to do, and I will do it’. So when we invoke the efficacy of the law in order to legitimise the norms and standards, rules and regulations our appeal has no epistemological relevance, and thus leaves intact all the sceptical arguments about the abuse of the law, witness intimidation, rich v poor, jury tampering, acquittals and equality before the law. We may certainly define the law by reference to the criteria of efficacy: this is not self-contradictory; nevertheless it is arbitrary; to accept it requires an act of faith and moral suasion and therefore the principle of credo ut intelligam may operate across the law. Given the simple fact that very few of us are ‘either saints or absolutely corrupted’, there is no moment in our lives in which we do not observe the x-law, in which we do not deserve, in terms of perfect justice, to be both chastised and rewarded (Kolakowski, 1982, p44).

**Heuristics**

The direct assessment of individual acts was eagerly debated during the 1960s and 1970s in terms of the choice between act- and rule-utilitarianism, and the many proponents of ‘rule-worship’ debated with moralists and philosophers whether the calculus should be applied to the act or to the rules according to which acts are judged. Hayry (1994) provides an excellent overview on the earlier debates. Modern critics of rational choice have advocated another approach to understanding the law, wherein a fact-finder might ask: what will happen if I fail to act? Certain formulations or general principles are used to help navigate in an environment that is not a well-ordered setting — with the occasional disturbance — as described by the rational choice scholars, but instead is fundamentally uncertain and characterised by complexity (Gigerenzer and Engel, 2006).

The heuristic school, as it has become known, offers a cross-disciplinary approach with contributions from experts in law, psychology and economics; they have a common denominator, and it is in the search for behavioural characteristics, a behavioural law and economics. The arguments in this book extend the arguments in McNutt (2005) and are centred around the political
economy of law, with an emphasis on ‘law’ in this context referring to the law
per se as we have come to understand it, codified and statute, and to the legal
environment that supports the law. Individuals adjudicate, prosecute and
defend other individuals in the legal environment, institutions evolve and
precedents are set, justice is administered and harm is punished. Costs are
incurred and benefits are obtained from the x-law. It is tangible.

Many years ago, Leibenstein (1976, p155) commented that ‘in real life
situations non-parametric problems can be turned into parametric ones if
individuals find it suitable or useful to behave in predictable ways’. We want
to focus attention on the circumstances in which the set of alternatives open
to each individual either involves predictable behaviour or does not. Law has
to be obeyed. It is predictable. Law is nothing if not the adherence and
adoption of rules and rights. There are rules and regulations, standards and
obligations, duties and performance. Adherence to the rules provides an
optimal outcome for all n parties and if all (n-1) adhere to the law, one can
deviate and break the rules. There are costs and benefits; each individual must
consider that if one moves away from adhering to the rule the other may do
likewise. A fact-finder might adjudge that for a reasonable person, if the costs
of non-compliance are less than the benefits of compliance, a rational choice
is not to comply. However this is compounded by a basic problem facing each
individual: the degree of predictability of the responses of the other
individual.

The optimal strategy for a rational individual is to take the effect of
learning about law’s performance into consideration in choosing to comply or
not. For example, adapting Goering’s (1985) consumer model, if we assume
that criminals know the law and if we assume that they also know that x-law
is uniformly distributed then the decisions of otherwise identical criminals are
based on individual expectations about the probability of acquittal in an x-law
environment. A random recidivist is able to experience the law in an x-law
environment. Perfect learning then occurs. The remaining recidivists acquire
no new information with which to revise their experience and expectations
and recidivism continues.

Shubik’s Dollar

So why should a rational party adhere to a rule or standard? The answer is not
clear and appears to depend on context. In Chapter 7, for example, we argue
that legal redress can be observed as an exchange disequilibrium converging
to a trading outcome agreed by both parties. It depends on how the law
performs and how it is enforced. But there may be a more subtle answer in
that observed adherence to the law is a signal of limited resources in seeking legal redress. Shubik's (1971, p75) party game captures the idea. A dollar is auctioned with bids in units of 5 cents. The high bidder wins the dollar and pays his bid, but the second-highest bidder also pays. It is easy to see that a dollar may be sold for considerably more than a dollar when individuals keep bidding in order to minimise their losses. So the costs incurred in an x-law environment are the opportunity costs of non-compliance and non-adherence to a mutually agreed law in the first place. It is as if the cost of moving away from the law – the norm or standard – includes the potential disutility that results from seeking legal redress in an x-law environment where costs may be high. Later in the chapter we will argue that x-law is an experience good because the effect of learning about the law depends on the information acquired in an x-law environment, that is, whether the law is enforced.

Political Economy

Political economy has a rich heritage in use, from a time when thinkers and philosophers built an architecture of ideas in support of an economy of people and citizens, a real economy of work and productivity, taxes and redistribution, a real economy within which a solution had to be sought to balance the insatiable wants of the rich and the basic needs of the poor. When it could be demonstrated at the margin that £1 from a rich individual with £1000, redistributed to a poor individual with zero income, would increase total benefits overall to the society, taxation was created, and with it a set of checks and balances and a set of laws that a reasonable person would adhere to in time. But we have too many laws and too many rules such that a reasonable person can be observed acting in what can only be described as wholly unreasonable within the reign of the law. We return continuously throughout the book to this theme of individual behaviour, but here (Case Study 1.1) repeat a story from Howard (2009).

Case Study 1.1 FULFIL ONE’S DUTY OR APPLY THE LAW

At a school in Florida, a five-year-old girl decided to throw everyone's books and pencils on the floor. Sent to the head teacher's office, she continued to wreak havoc. Her teachers dared not restrain her physically. Instead they summoned the police, who led her away in handcuffs, howling. The teachers acted as they did for fear of being sued.
The law had set a precedent. A teacher at a different school was sued for $20m for putting a hand on a rowdy child’s back to guide him out of the classroom. The school ended up settling for $90,000. What this indicates is a sense of forbearance amongst teachers frightened of violating pupils’ rights such that they allow disorder and havoc to persist. Once the pupils observe the havoc, the havoc continues. A reasonable teacher would be expected to instil discipline in a rowdy classroom by either removing the rowdy pupil in the knowledge that she is acting within the law, or punishing the rowdy pupil in the knowledge that other pupils are not only observing the punishment but that they also consent. Knowledge in this most fundamental sense is ideological, since it forms views of reality and solves problems from a social class point of view. A fact-finder may find it easier to rationalise the case of a poor man stealing from a rich man than the case of a responsible teacher punishing a rowdy child. If the socially desirable outcome is to be obtained – for example, a peaceful, well-organised and disciplined classroom – then a reasonable person ought not to have to only rely on the law but to act in a responsible manner by fulfilling her duty as a responsible teacher.

Rules

If a poor man steals $1 from a rich man his marginal utility gain exceeds the marginal utility loss of the rich man, so total welfare has increased. The rich individual has worked and earned the £1000, yet any comfort from the monies earned can be dissipated by costs of security measures to prevent the poor individual stealing the monies. In addition to personal security measures that a rich individual may adopt, the creation of a public sanction against stealing and crime may dissuade the poor individual from violating the rights of a rich individual. We return to this later in the chapter in our discussion of the Apple Thief Paradox.

Alternatively, a reasonable person may be expected to ask: why not trust the rich individual to redistribute £100 to the poor individual? Equivalent to an effective tax rate of 10 per cent, a fact-finder would apply a calculus to the likely disincentive effect of such a rate weighed against the moral hazard of the poor individual, whom in the knowledge of a certain sum of £100 would be less inclined to work and earn in order to subsist. So why redistribute at all? Does it deter stealing? Some may argue that stealing is morally wrong for the rich man and sometimes morally right for the poor man, because the respective prohibitions on one group and permissions for another actually increase total welfare at the margin. Thus, marginal stealth could be justified.
Reason

However, if individuals were completely causally determined then any attempt to conceive of a rule that prescribes or limits the means by which some end can be achieved is pointless. Having the ability to make judgements and apply reason puts us outside that system of causally necessitated events. In its intellectual domain, reason must think of itself as free. An extension of this philosophy is therefore that human beings act as a means to other ends than to an end in itself. If we accept that it was this desire for a ‘means to other ends’, which largely formed the breakdown of corporate governance in the early part of the twenty-first century then we can argue that key areas of moral philosophy could be built into an economic model.

So, in order to precipitate a wider debate, in order to capture the essence of political economy, we should reconsider the redistribution action in terms of the language used: by substituting ‘rich’ and ‘poor’ with random individuals A and B we are less inclined to allow value judgements impinge on our decision. The redistribution is now less personal and more distant, allowing a random fact-finder to comment and observe, criticise and praise, adopt or reject a set of solutions or actions, and to qualify behaviour that may be acceptable to all individuals. Behind what is essentially a Rawlsian veil of ignorance there is every possibility that a random fact-finder, faced with the same information constraint, would adopt as a minimal morality the ethic that you do onto other individuals what you would wish them to do unto you, an ethic that is embedded in so many of the ancient philosophies and religions of the world.

CORNERSTONE ETHIC

Political economy has its origins in the ancient philosophies and religions, and in every civilisation efforts were made to implement and adopt what we call a ‘cornerstone ethic’ that could be handed down to future generations. From the origin of money to the division of labour, from property rights to common good, from punishment to retribution, from anarchy to government, a cornerstone ethic has evolved, and that we regard as a fundamental building block in the political economy of law perspective. It is an ethical perspective that focuses on three clearly defined principles viz equity, fair distribution of a burden and social justice, and two observational trends in an x-law environment viz G-group convergence and social norms v institutions.

The arguments in Chapter 4 on accident deterrence and liability work from
a premise that a rational tortfeasor would continue to violate the law since taking due care is not a dominant strategy in the sense that it is the best available action regardless of what the other party does. There would be no need for a court, for example, to rationalise a party's action as being optimal given the other party's action or given the court's belief about the other party's action. No matter what the party (the tortfeasor) believes her opponent (the victim) will do or no matter what the opponent in fact does, she will not deviate from a dominant strategy. In the absence of a dominant strategy of taking due care, strict liability may be the preferred rule of liability for a deviant tortfeasor. Within law and economics paradigm strict liability is more efficient when there is unilateral precaution, and only one party is looked to for precaution, the party with no dominant strategy to take due care.

The elasticity of due care co-efficient in Chapter 4 could play a key role in understanding deterrence. Given this co-efficient a fact-finder can think of deterrence as varying along a single dimension, $0 < \alpha < 1$: for the policy-maker $\alpha > 0$ if increased accident prevention costs, for example, increase due care, and for the tortfeasor $\alpha > 0$ if increased expected costs increase due care. The coefficient represents the strength of the deterrence measures. Law enforcement is a policy tool that affects the elasticity of due care, and thus the efficiency of law as experienced in an x-law environment. By determining the effects of changes in policy tools on changes in the elasticity, a fact-finder could determine the efficiency effects of a different policy option. If the tortfeasor is rational, his or her behaviour would hinge upon a comparison of expected costs and benefits. If, however, he or she is uninformed about punishment and detection rates, then they may not respond in the desired way. There are problems of bounded rationality and there are problems of opportunism in the functioning of law — law has its limits.

**Political Economy of Law**

In Chapter 7 we consider a 'caring defendant model' wherein the asset of unknown value is a commoditised 'no crime committed' good. Could one intuitively inform a debate on crime prevention by superimposing the economics of intergenerational transfers so that one individual, a defendant, trades with another, a plaintiff without recourse to the law? The essence of how and why any trade should take place between a defendant and a plaintiff has never really been discussed within the law and economics paradigm outside the analysis of plea bargaining (Ehrlich et al., 2006). Within the economics literature, the trading between young and old in terms of inter-generational transfers of wealth has been reviewed since Samuelson's no-
trade equilibrium in the 1940s. The challenge for a fact-finder is to rationalise how it could arise that the victim of a crime could trade a commodity ‘no-crime’ with the defendant. Potential victims take precautions not to become a victim; and why should a criminal defendant trade with the victim when there is no guarantee of compensation at least equal to the opportunity cost of the crime? We hope to answer these questions in Chapter 7.

In the political economy of law, the good exchanged has an intrinsic value that differs for each plaintiff though it may have a given value for the defendant. A caring defendant is prepared to desist and receive a payment. From whom the payment is made may be irrelevant to the defendant – it could be plaintiff A or B. The caring defendant model illustrates an exchange of a commoditised ‘no crime committed’ good; if the exchange, f, has a correspondence value and not a functional value, so that ‘no crime’ is then a positive externality for n individual: the gain accruing to one individual is interdependent: $y_j = f(x_n)$, where $n = 1,2,3,...,n$. Across the literature, Benabou and Tirole (2006), scholars have considered preferences that take into account attitudes toward the behaviour and intentions of others.

Rational individuals commonly engage in activities that are costly to themselves and that primarily benefit others. Examples are cited of volunteers, helping strangers, giving to charities, donating blood, joining rescue squads. The literature looks at the broader set of motive that shape people’s social conduct, and how these motives interact with each other and the economic environment. Peoples’ actions do indeed reflect ‘a mix of altruistic motivation, material self-interest and social or self-image concerns … crucially, altering any of the three component of motivation, for instance through the use of extrinsic incentives or a greater publicity given to actions, changes the meaning attached to pro-social (or antisocial) behaviour and hence feeds back into the reputational incentive to engage in it, (Benabou and Tirole 2006, p1674). When more agents opt for reciprocal exchange, markets thin and it becomes optimal for agents to engage in personal exchange.

Sharing the Costs of a Decision

A political economy of law believes that the essence of morality is to be found in reason: it is by a process of rational deduction (as distinct from religious faith) that one could discover the basis of right and wrong. In our discussion of the Fable of the Bamboo Flute (McNutt, 2005), you the reader are the fact-finder, the arbiter of a dispute between three individuals over ownership of a bamboo flute. As a fact-finder, you arrive during the dispute and the three individuals unanimously appoint you as the arbiter. The resolution of this
allocation dispute, which is quintessentially a dispute about ownership of a resource, is contingent on the information available to you as arbiter. Your actions are mutually exclusive, and your choice, once made, is irreversible.

If the information set available to you is simply that the first individual 'made the flute', and if you were persuaded by a Marxian-Nozickian (Nozicks, 1974) rule of allocation, you would allocate the flute to the first individual. If, however, the information set is that the second individual 'can play the flute', and if you were persuaded by an older Benthamite-Utilitarian (Bentham, 1823) rule, you would allocate the flute to the second individual. And finally, if the information set available to you is that the third individual is 'the poorest individual', and if you were persuaded by a Rawlsian (Rawls, 1971) rule, you would allocate the flute to the third individual. Your decision is based on a set of ethical rules and inevitably the rules are value-based, yet they are an integral part of your decision-making as an arbiter (Jackson, 2008).

A more general version of the problem of the Fable of the Bamboo Flute is that there may be different efficient outcomes to any resource-allocation problem that efficiency alone may not be strong enough a criterion to give very clear explanations for the fact-finder of policy-maker. However, when the simplifying condition of no wealth effects is satisfied, only one pattern of behaviour is consistent with efficiency, and that is the pattern that maximises the total value created in the transaction (Milgrom and Roberts, 1992, pp35-8). This is the value-maximising principle and it is a good example of the application of the Benthamite-Utilitarian rule to the resolution of an allocation problem within the law. Law often focuses on the end-state.

Table 1.1 To whom do we allocate?

<table>
<thead>
<tr>
<th></th>
<th>Made the flute</th>
<th>Can play the flute</th>
<th>Very poor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual A</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual B</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Individual C</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Outcome</td>
<td>A gets the flute</td>
<td>B gets the flute</td>
<td>C gets the flute</td>
</tr>
</tbody>
</table>

There is however, at least a fourth scenario to the Fable that is of interest to the discussion as it unfolds. The fact-finder arrives at the dispute and all three pieces of information are made available to the fact-finder to assist in reaching a resolution. In this particular context the fact-finder is defined as
information constrained or ‘bounded rational’ in the exercise of his or her decision-making (Simon, 1957). If the preferences of the three individuals display no wealth effects, Coase (1960) proposed that the outcome on which they agree will not depend on their respective bargaining power nor will it depend on what assets each owned when the dispute began. Rather, efficiency alone determines the outcome McKenzie (2008) asks: do economists make markets?

The principle that efficiency alone can determine the outcome has evolved within law and economics as a celebrated proposition, known as the Coase theorem. The other factors can affect only decisions about how the costs and benefits are to be shared. Therefore the relationship between efficiency and ethics becomes complex. In many cases, ethical norms evolve to sustain cooperative behaviour ‘and thus to promote successful functioning of social institutions’ (Shleifer, 2004). For example, the ethical condemnation of corruption is based on the idea that a society functions better when its government and corporations work fairly.

Deontological Ethics

Law is the embodiment of rules that look at the end-state of a dispute, for example, a dispute over an agreed contract or a dispute over property rights. But is there a right of fair outcome to the dispute? Is law fair? If the decision-maker is a rule utilitarian then she will work according to the maxim that if everyone acts according to the same rule, social welfare (the sum of utilities) will be maximised. Within law and economics, game theory continues to provide a new dimension to rational deduction. Games are rule-governed social interactions characterised by strategic interdependency (Baird et al, 1994). In an ultimatum game a player (the proposer) is asked to decide how to split £10 by making an offer to another player (the responder). If the offer is rejected, both get zero. Self-interested rationality predicts that the responder should accept any offer greater than zero. The proposer, anticipating acceptance, should offer the minimum amount. In some experiments, the lowest offer was £1, and the highest was £5.

Chryssiades and Khaler (1966) have argued that Kant’s deontological focus in determining whether an action was morally ethical was on the intention of the action, rather than its consequence. He asserted that to act ethically was to act from duty. He distinguished between two types of duty and he called these imperatives \textit{viz} (1) hypothetical imperative – we do something to get something else; for example, we work to earn money; (2) categorical imperative – we do something without an end in mind. There are
no boundaries, no ‘ifs’ and no ‘buts’. The categorical imperative is the fundamental principle of Kantian ethics. For example, if an organisation acts honestly with the intention of gaining a good reputation then this is not a genuinely moral act in Kant’s view. It is only a truly moral act if the organisation acts honestly because honesty is right – it is the organisation’s duty.

The Golden Principle Plus

It has been argued that the ‘golden rule’ principle is the most important principle of formal ethics, Gensler (1996). To apply the principle you have to imagine yourself in the exact place or set of circumstances of the other person on the receiving end of your action. The allocation problem in Table 1.1 could be resolved by the golden principle if the fact-finder considered what it would be like to be one of the individuals. If he considered what it would be like to be poor, then he may appeal to the golden principle and allocate the flute to individual C. However as argued by Gensler (1996, pp93-5) the golden principle ‘is not an infallible guide on which actions are right or wrong: it doesn’t give all the answers’. The law provides a rule. If the set of circumstances before a fact-finder were to change so that an individual was identified as the thief, then that individual would not be awarded the flute. A political economy of law perspective requires of the fact-finder to take a broader view, to take account of what we define later in this chapter as the singularity and unambiguity of law. A broader view is required when the fact-finder is bounded rational or information constrained, when there is inconsistency in the facts. For example, the fact-finder believes that individual A is the thief, but in fact, it was Mr B who stole the flute, which led to the observed dispute.

The net issue is the belief structure of the fact-finder, the facts that may have contributed to the belief, his prejudice, self-interest, experiences of observed disputes. Mr A has the right to seek legal redress in this hypothetical situation. In other words, the law is the ‘golden principle plus’, where ‘plus’ allows for external interests such as legal sanctions, loss of respect, guilty complex, bounded rationality, lack of knowledge, ignorance of the facts. The golden rule is a rule for altruists in a world of altruists. The golden rule is not golden because it promotes self-interest – rather promoting self-interest makes a rule golden. Adapting Gensler’s argument that Kantians would be pleased with altruists because ‘altruism is good whether or not it promotes self-interest’, a fact-finder sees that people are happier if they desire to do good to others for their own sake, so he tries to develop this desire himself. If
he succeeds, then he will no longer desire to do only what promotes his self-interest. Instead he will desire to do good to others for their own sake.

Precise on Kantian Ethics

The literature focuses on three main formulations that Kant proposed for his categorical imperative. Bowie (1999) defines them as follows: ‘Act only on maxims or principles that you can will to be universal laws of nature’; ‘Always treat the humanity in a person as an end and never as a means merely’; ‘So act as if you were a member of an ideal kingdom of ends in which you were both subject and sovereign at the same time’. In order to determine what this implies for a moral framework in a modern organization, we must first understand the formulations. The first formulation of Kant’s categorical imperative tests whether an action is moral by questioning whether it can be applied universally. Is a world where everybody abided by that maxim possible? For example, ‘I will steal from people’ cannot be universally applied as it becomes self-defeating (and therefore immoral) if everybody steals.

Kant’s second formulation implies that a person cannot use another to satisfy their own interests. In Kant’s words, humans have free will and act according to reason – they therefore have a ‘dignity beyond price’. This point perhaps has important moral responsibility considerations for laboratory experiments in the pharmaceutical and cosmetic industries. Does a Kantian ethic necessarily imply that since animals do not have free will, that pharmaceutical testing is morally acceptable to prevent a later suffering of a human? For that action to be morally right, a fact-finder must not be deceived as to the reason for animal testing, and provided the animals are humanely treated, the morality of the action could depend on the free will of the fact-finder who acts according to reason. Bowie (1999) discusses a third formulation of the categorical imperative — that rules that govern must be endorsed by all.

Ethics First, Law Second

Against this background we may ask if it is possible to develop a template on ethics first v law second within a political economy of law paradigm. Working from the premise that moral law is by its nature universal – Kant’s golden rule — in the sense that it applies to everyone unless we can demonstrate that we are in circumstances which warrant an exception, then putting ethics first and law second in dispute resolution is conditional on four conditions. First, that
there is a social bond or understanding between different groups in society, G-groups; second, that transactions costs, for example legal costs, are non-negative; thirdly, that there are informational disadvantages across the parties to a transaction due to experiences of the x-law and finally, that a party can be 'captured' or persuaded by another to do the 'right' thing. For example, a fact-finder with a prejudice against flute thieves may allow self-interested motives independent of all the relevant facts, to influence his decision in Table 1.1.

There are four paradigms illustrated in Table 1.2. The box in the top left-hand corner represents Kantian ethics where rational individuals fulfil their duties and act responsibly. The law and economics paradigm is located in bottom left-hand corner of Table 1.2 because the ethical foundation in the economics underpinning the approach is end-state maximising efficiency. The bottom right represents the law where law is first and ethics is second in the marshalling of legal arguments. The top right-hand box represents the political economy of law paradigm where ethics is first and the law is second in reasoning. The law is second because it is trumped by the x-law, the experience of the law that informs the behaviour of rational reasonable individuals to act within the law.

Ethics first and law second is deontological. It embeds the morality of the golden principle into decision-making as the focus turns on rational reasonable individuals fulfilling duty. A fact-finder now believes that the sole feature that gives an action moral worth is not the outcome that is achieved by the action, but the motive that is behind the action. Therefore, in Kant's view, moral actions are actions where reason leads, rather than follows. The fact-finder is free to act and should take cognisance of other individuals who act responsibly according to their own experience of the law.

Table 1.2 Ethics and law

<table>
<thead>
<tr>
<th>Ethics</th>
<th>Law</th>
</tr>
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<tbody>
<tr>
<td>Ethics</td>
<td>Kantian ethics</td>
</tr>
<tr>
<td>Law</td>
<td>Political Economy of Law: x-law</td>
</tr>
<tr>
<td>Ethics first, Law second</td>
<td></td>
</tr>
<tr>
<td>Law</td>
<td>Law &amp; Economics</td>
</tr>
<tr>
<td>The Law</td>
<td>Law first, Ethics second</td>
</tr>
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Kant argued that one's duty is to be done for duty's sake. Morality is not the same as self-interest, or even benevolence. If the fact that Mr A is an
employee were the reason for treating him well, then management would be let off the hook if, say, management were to quarrel with him, and the friendship were to come to an end. In other words, feeling of friendship or compassion for others cannot constitute truly moral grounds for acting. The moral law, Kant argued, was to be obeyed because it is the right thing to do, not because of any consequences, which accrue to moral behaviour.

**Law and Business Ethics**

The duty of an individual is the priority and this is separate from the notion of good. By focusing on the action itself, rather than the outcome, a fact-finder is able to distinguish between responsibility and accountability. A person is responsible for performing their duty and can be held morally accountable only if they fail in performance of this duty. Whether the outcome is ‘good’ or ‘bad’ is not morally relevant to determining reward or punishment, it is the performance of the duty that is relevant to Kant. So it is in law. It is the performance of law that defines our experience of the law.

Lawyers have a duty to ensure that the law is performed in a socially desirable manner. They are faced with issues to do with business ethics as they deal with the various elements of moral responsibility and accountability encountered by organisations and companies. These may include general moral responsibility, social responsibility, executive responsibility and corporate governance. Many business decisions involve an ethical dimension. Indeed in many cases the decisions involve moral dilemmas. For instance, should businesses such as The Body Shop test their new perfumes or lotions on animals or human beings and risk human life? What of institutions like Friends of the Earth who can campaign against such companies and lobby for their licenses to be withdrawn by governments? Law is informed by individuals fulfilling their duty and acting responsibly. Some may argue that ethics is not necessarily law, but a fact-finder might argue that if the fulfilment of one’s duty can have an adverse impact on another individual’s primary objective of profit maximisation then the law may change to reflect that fact. Ethics first and law second, or is it law first and ethics second?

**Ethical Dilemma**

A duty results in a responsibility and the performance of a duty results in either praise (reward) or blame. Failure to fulfil a duty makes one accountable. X presents a dilemma simply because X has occurred, but if Mr A was doing his duty then X would not have occurred. The emphasis is on Mr A not fulfilling his duty, and as a consequence of that failure to fulfil, an
ethical dilemma arises: who is responsible? At one level, of ‘ethics first’, Mr A is responsible whereas on another level, ‘law first’ Mr A is protected by the law or the x-law of norms and standards, and is not responsible for X.

In trying to reconcile this dilemma, there are two aspects to business ethics that are of interest in a political economy of law paradigm viz (1) specific issues giving rise to ethical issues; and (2) principles of behaviour by which stakeholders expect business to behave as moral citizens. There is substantial research into the subject of business ethics with modern business trends where customers are becoming more and more aware of their rights and knowledge of the products and services they purchase. Across the literature (Monks and Minow, 2006) there is partial agreement on a range of perspectives of business ethics within the meaning of ethics as a norm. They define a space in Table 1.3 in which the ethics first, law second perspective for business ethics could be outlined and discussed.

Many argue that Kant advanced certain arguments for business ethics (Bowie, 1999); Chryssiades and Khaler (1996). However not all of Kant’s perspectives would necessarily agree with the five outlined in Table 1.3. The general basis of Kant’s perspectives was that the essence of morality was to be found in reason as distinct from faith. His reference to faith might have been based on the thinking in the eighteenth century that morals were to be judged by obedience to faith as taught by the established Church. In this chapter we are suggesting that an underpinning for business law is a moral law, a law that should be obeyed because it is the right thing to do and not because of the consequence that would accrue to the business.

Table 1.3 Tableau on business ethics

<table>
<thead>
<tr>
<th>Perspective</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business is business</td>
<td>It is the customer’s duty to obtain all necessary information about the goods and services they buy; this suggests that profit is paramount and no ethics are considered</td>
</tr>
<tr>
<td>Act consistently within the law.</td>
<td>Strict adherence to compliance to law; suggests that if no law is breached then profit is preferred to ethics</td>
</tr>
<tr>
<td>Good ethics is good business</td>
<td>Good ethics and good business coincide in terms of results; customers are comfortable with ethical companies than otherwise resulting in repeat business and more profit</td>
</tr>
<tr>
<td>Conventional morality</td>
<td>Business is done according to conventional standards of morality</td>
</tr>
<tr>
<td>Universal morality</td>
<td>No difference between business morality and private life morality</td>
</tr>
</tbody>
</table>
Moral theories based on human rights (natural law theory) are advocated as alternatives to Kant's theory. It would be unethical, for example, to deny workers the right to trade union affiliation, works councils and fair wages and other benefits (where practical) such as share options. However, Kant's moral philosophy has a number of problems in that the concept of a universal maxim is not always valid. He considers that moral theory is independent of its consequences and circumstances, which in the real world is not always the case. In a Kantian world, morality was to be universal and it was to be applied without exception on the basis of friendship or favour and across all countries. But what is right and what is wrong? Is it wrong and immoral for a reasonable person not to call an ambulance for an injured person simply because she was not a relative or friend? The Kantian test is to ask if it is right or wrong to do that regardless of relationship or consequences. Law recognises that individuals also have rights which should be protected and defended.

**Ethical Awakening**

So is it possible to transfer the Kantian test into business ethics? We could begin with the neo-classical premise that organisations exist solely for profit. But the moral landscape has changed for business. Ethical sourcing of raw materials, health and safety and minimum wage legislation, for example, have imposed new requirements on business. Customers have rights and it is their duty to get product information. Executive management is responsible to stockholders not only for profit maximisation but for guidance on corporate social responsibility. The modern organisation now takes into account the interest of the wider stakeholder community including employees, customers, suppliers and government. The knowledge of consumer rights and those of other stakeholders have forced the organisation structure to take account of the duties, responsibilities and accountability of businesses. More businesses are managed by people who are not owners, and the agency problems that arise are costly, when management pursue their own interest at the expense of the owners of the business.

In order to embrace moral responsibility and accountability within an organisation there needs to be a hierarchy in place, a *code of ethical practice* that clearly demarcates the duties of each employee, Demidenko and McNutt (2008). For the structure to have a degree of functionality within an organisation, a matrix of duties could be defined and individuals are then informed as to whom they are responsible. For instance management to staff, staff to management, and management to board relationships should be clearly defined. This would involve determining or understanding where duty
is owed. Moral responsibility within an organisational structure can best be illustrated as shown in Figure 1.1 by a causal chain borrowed from Chryssiades and Khaler (1996):

```
Responsibility
  
  Duties owed
  
  Casual responsibility
  
  Accountability
  
  Due recognition
```

*Figure 1.1 Kantian Responsibility*

Some responsibilities may be general while others are role-specific. For instance a medical doctor owes duty to his patient and is responsible to the patient for the performance of that duty. Once the structure is determined it is then easier to determine casual responsibility. This causal responsibility enables judgement of either accountability or due recognition. Moral responsibility in the Kantian dialectic depends on whether the moral responsibility is role-specific or general. Accountability arises out of failure to fulfil one's duty; if Mr A fulfils his duty then a socially desirable outcome is obtained and due recognition for Mr A results from his superior performance.

**PERFORMATIVITY OF LAW**

But does the law create markets in the administration and application of the law? The answer is in the affirmative. Criminal law, for example, creates the need for defence lawyers, a criminal justice system courts, and *inter alia*. So the real question is whether the markets created are efficient. For example, there has been no clear statistical evidence linking increases in sentences to reduction in the crime rate, Vardy and Grosch (1999, pp184-5). Some argue that prisons are 'schools for crime' while others, who hold to a retribution
theory of the law, maintain that punishment should equal the crime. It is a matter of debate in legal circles whether a life sentence can be every bit as severe as capital punishment. With so many factors and so much uncertainty it is impossible to determine the efficiency of x-law markets. Lord Devlin, as reported by Vardy and Grosch, maintained that a recognised morality is as necessary as a recognised government.

If Devlin’s view were accepted, they argue for instance that ‘the law could be used to enforce institutions such as marriage, the family, adultery, divorce or monogamy, and these would become matters for the criminal courts, (pp185). Hart (1961a, 1961b) had disagreed; he maintained that a society can only enforce universal morality and not ‘its own, relative morality which can depend on culture and time’. We begin with the premise that law and x-law are strategic substitutes in the sense that law facilitates an ability to punish and x-law provides the capability to avoid punishment for a crime. This allows us to explore in greater detail the performativity of law and how it interacts with society. By introducing regulations and eventually standardising norms and rules as the law, in the absence of which we have a degree of lawlessness, the law exists.

**Corner Solutions**

In exploring these structures we can identify incentives and the trade-offs individuals incur in adhering to the law or disobeying the law. With a changing economy the law will perform provided that a proper transactional environment can be established and supported by social institutions. For example, law brings with it legal precedent, a specific asset to society, an acceptance if you will that decisions are not always fully flexible. However in the absence of fully flexible decisions common sense may not prevail. If law and x-law are jointly produced as goods in society the outcomes will evolve towards corner solutions as rule-makers seek to eliminate small risks, and unintended consequences proliferate in society. For example, bureaucrats ban children playing in the school yard for fear they fall and break a leg. So the children stay indoors and get fat. Law enforces standards and norms; however law only becomes law when the standard or norm is performed by an individual:

\[
\text{Law} \rightarrow (\text{Norms, Standards, and Rules})
\]

Either Mr A adopts the standard or Mr B’s failure to adopt results in legal argument and representation as a defendant in a court of law. The performance
of the lawyer can often assuage Mr B's failure to adopt. Adoption of a standard and ultimately the performance of law can depend on observed behaviour, that is, Mr B observes Mr A adopting the norm and *vice versa*.

**Table 1.4 Law**

<table>
<thead>
<tr>
<th></th>
<th>Norm I</th>
<th>Norm II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Norm I</td>
<td>1,1</td>
<td>0,0</td>
</tr>
<tr>
<td>Norm II</td>
<td>0,0</td>
<td>1,1</td>
</tr>
</tbody>
</table>

If both individuals adopt I or II they are better off and the optimal outcome (1,1) is obtained when each observes the other adopting the norm and they both coordinate their actions. The law acts as a conduit to affect the optimal outcome when any two individuals can observe simultaneously their respective unilateral actions, that is, adoption of a norm. There is no scope for error or mistake. If one individual opts not to adopt norm I and chooses norm II then the (0,0) outcome obtains and both individuals are worse off.

This can explain adherence to driving on the right-or left-hand side of the road. For example, in the US the norm is to drive on the right-hand side of the road; if Ireland, the norm is to drive on the left-hand side of the road. Provided a random US driver observes all US drivers adhering to the norm and provided a random Irish driver observes all Irish drivers adhering to the norm, the optimal outcome (1,1) will obtain. However, if an Irish car driver, arriving in the US, opts to drive on the left-hand side of the road, (0,0) will result and there will be a fatality.

Therefore observed performance embodies the law in this instance. Law is obeyed because performance is observed. If an individual complies with the law there is no legal dispute. For example, the burglar, the thief, the tortfeasor and the criminal represent individuals who do not comply with the law. There are norms and standards where failure to perform results in an x-law environment. So what is x? The x variable includes legal representation in a court of law, written affidavits, legal language jury selection in a criminal trial, the observed facts of the case, and the judge presiding *inter alia*.

In the case of Mr B, he observes not only the law but also that the law is broken, that is, in an x-law environment, Mr B observes that the law is not adhered to by all if the costs of not adhering to the law outweigh the benefits and Axiom I holds:

**Axiom I:**

\[ C(x\text{-law}) < B(\text{law}) \]
Singularity in Law

Many would argue that law is objective, and thus singular, and that law refers to a set of rules, norms and standards that can be repeated and consistently applied. A framework to understand the law – x-law dichotomy might use something like Occam’s razor: if norms or rules or standards are only law then why insist on their action? Is the norm different from its x-law performance or representation? In the x-law the interpretation of a norm can be challenged and it is often the language of the law that underpins the x-law, and ultimately the performativity of law.

If Axiom I is followed then law is not performed (optimally) and a fact-finder could argue a case that performativity of law as understood by critical legal scholars is embodied in an x-law. In building such a case a fact-finder would marshal a set of arguments around the language of law and its performances and thus facilitating a fact-finder to test the hypothesis that law fits both singularity and unambiguity. The fact-finder’s objective is to determine whether or not law reflects the experience beyond the law; if not, then x-law does.

In order to understand the x-law, it is imperative to recognise that one individual in the x-law environment can ‘holdup’ the payoffs of another individual. It is as if each individual or party to a transaction is a hostage of the other (Shubik, 1971). Later in this chapter we refer to the parties as G-groups. The hostage dilemma can be simply illustrated in Table 1.5.

Table 1.5: x-law

<table>
<thead>
<tr>
<th></th>
<th>Norm I</th>
<th>Norm II</th>
</tr>
</thead>
<tbody>
<tr>
<td>Norm I</td>
<td>1,1</td>
<td>2,1</td>
</tr>
<tr>
<td>Norm II</td>
<td>1,2</td>
<td>2,2</td>
</tr>
</tbody>
</table>

In this matrix of payoffs, coordination is necessary as in Table 1.4. However, each cell of the matrix in Table 1.5 represents a Nash equilibrium, whereas two Nash equilibria (1,1) and (1,1) can be found in Table 1.4. The x-law requires each player to evaluate each other’s worth in terms of norm I v norm II since potential plaintiffs have a positive wealth effect and potential defendants may have limited resources. Within the x-law environment there is a need for what Strauch (1981) had called ‘a transfer of understanding’ across the parties. As law performs and is observed in an x-law environment, a reasonable rational person may wonder about paying for an x-law environment that he or she never uses. It is only when a reasonable rational
person morphs into a defendant or plaintiff that x-law matters. If all individuals adhered to the norms in Tables 1.4 and 1.5, and mere adherence to the norm was observable, then in this stylised example one might ask whether or not we need a law enforcement agency.

**Unambiguity in Law**

But can the law constrain the results reached in an x-law environment by lawyers in legal disputes? Scholars in critical legal studies would argue no. This implies that disputes cannot be easily resolved with clear unambiguous answers and that there is at least some uncertainty in legal reasoning. What has been described elsewhere (McNutt, 2005) as ‘the indeterminacy thesis’ evolved in debate as a challenge to Dworkin’s ‘right answer’ hypothesis wherein he argued that nothing is law unless it has been implemented by a legislature or a judge. A political economy of law would recognise an x-law environment wherein the law is tested and mistakes or errors in the language of the law can be adjudicated upon. An x-law evolves as individuals, practitioners, adjudicators, lawyers and judges attempt to promulgate the law as they test the language of the law in its objectivity, its singularity and its unambiguity.

**Lemma 1**:

Adapting Hojka (1975), we define an x-law Lx as unambiguous if the mapping f(Lx) → f(L) is bijective. Otherwise L is ambiguous.

In our earlier example of the car driver, an optimal outcome (1,1) is obtained provided both individuals adhere to the law: norm I or norm II. Either norm applies to both simultaneously. But consider a norm III: no individual or person should use a mobile phone when driving. A positive Hartian view would contend that norm III is objective because norm III fails to recognise the mistake as legally valid. Therefore you the reader may use your mobile phone while driving. This perspective can be understood in the context of (Hart’s, 1961a) view that all laws are commands that impose a duty or obligation on an individual. You the reader have a moral obligation to obey norm III but whether you do or not depends not only on your sense of duty and responsibility but also on what you observe in the performance of norm III as law. If you observe non-compliance by many or minimal enforcement or leniency in the prosecution of norm III — Axiom I applies — then it is the x-law that informs your decision.

Therefore within a political economy of law, every law has an x-law: the law — x-law dichotomy can be understood in terms of three conditions, *viz*...
singularity, unambiguity and objectivity. Collectively, the three conditions define the performativity of law within a political economy of law perspective as shown in Table 1.6.

Table 1.6 Singularity

<table>
<thead>
<tr>
<th></th>
<th>Law</th>
<th>x-law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singularity</td>
<td>√</td>
<td>x</td>
</tr>
<tr>
<td>Unambiguity</td>
<td>x</td>
<td>√</td>
</tr>
<tr>
<td>Objective</td>
<td>√</td>
<td>x</td>
</tr>
</tbody>
</table>

Law is singular and thus objective. Morality and the law may overlap but you the reader and a random individual may have a different morality that cannot be changed, unlike the law. It is not unambiguous. The language of law translates law into a reality and creates an x-law in the pursuit of legal reasoning. On the contrary, x-law is neither singular nor objective. This can be explained in part by the public choice theory of rent-seeking and capture (McNutt, 1996). Also it is not easy to apply the law exactly in an x-law environment, for example in cases of theft where the defendants are poor. Also, crimes differ. The killing of a husband by a wife who has been beaten and bruised by him and the killing of a security guard by armed robbers 'are both killings, but the latter is surely in a different category from the former' (pp187) as argued by Vardy and Grosch (1999).

However x-law is unambiguous (Lemma I). A challenge to a norm or a rule or a standard by a plaintiff changes the law. Law is ambiguous. Posner (1998) had argued that many features of the common law could be explained by the conjecture that it was a set of legal rules that maximise economic efficiency. One weakness in Posner’s argument is the absence of a plausible mechanism to generate efficient common law. Is the law as a set of rules equivalent to what an economist would put in place to maximise economic efficiency? The answer would be in the affirmative if an individual’s morality or sense of duty and obligation ensures compliance with the law as experienced as a norm or standard or rule.

Table 1.7 Law as a norm

<table>
<thead>
<tr>
<th></th>
<th>Law</th>
<th>x-Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singularity</td>
<td>√</td>
<td>x</td>
</tr>
<tr>
<td>Unambiguity</td>
<td>x</td>
<td>√</td>
</tr>
<tr>
<td>Objective</td>
<td>√</td>
<td>x</td>
</tr>
</tbody>
</table>
Our argument in this chapter, however, is that x-law exists because it is efficient in the sense that property rights are abridged as discussed in Chapter 2. In general, however, law can be presented as a set of rules to be adopted, a norm or a standard for compliance. But x-law is an experience good — see Table 1.8.

**Table 1.8 x-law: An experience good**

<table>
<thead>
<tr>
<th></th>
<th>Law</th>
<th>x-law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singularity</td>
<td>x</td>
<td>✓</td>
</tr>
<tr>
<td>Unambiguity</td>
<td>x</td>
<td>✓</td>
</tr>
<tr>
<td>Objective</td>
<td>✓</td>
<td>x</td>
</tr>
</tbody>
</table>

Law does not reflect experience beyond the law, x-law does, and thus paradoxically x-law evolves as an experience good that fits both singularity and unambiguity but not objectivity. There is an important question to be considered in terms of commenting on the efficiency of law. Is a random burglar, thief, tortfeasor or criminal who experience x-law faced with a prisoners’ dilemma: choose law or x-law? The random individual who has implicitly chosen x-law (Axiom I) may be advised subsequently by learned counsel to plead guilty and thus recognise the law as the rule. In a naive case: Mr A, facing prosecution for using a mobile phone while driving, admits to the wrongdoing and receives a fine or admonition from a judge. In a sophisticated case: a recidivist criminal refuses to plead guilty having already observed (Axiom I) the significant role played by legal argument and reasoning within the court proceedings in the determination of the penalty or sanction.

**Apple Thief Paradox**

It is the strategic interaction between judge and jury, between defendant and lawyer and indeed between defendant and the law that creates a benchmark for behavioural law. Bureaucrats use litigation to avoid the constraints they face when they regulate the old-fashioned way by formulating rules that enrich our understanding of bureaucracy. Law is not randomly assigned to different jurisdictions so how the law evolved must be taken into account in determining its efficiency.

Strategic interaction also captures the unintended consequences of human interaction. Mr A steals an apple — no penalty, no sanction; Mr A steals a sum of money, £500, and is caught — there is a caution; Mr A steals a car, drives
too fast, knocks down and kills Mr B. Is Mr B’s death the unintended consequence of Mr A’s pattern of not fulfilling his duty? Initially, stealing an apple had no sanction, no penalty. Or is it that Mr A as an individual is influenced by the law in that no punishment for an apple creates a belief about stealing and punishment? For example, if Mr A were imprisoned for stealing an apple or Trevelyan’s corn, the experience in prison, exposed to a network of petty and hardened criminals, might dissuade Mr A. The power of dissuasion might influence Mr A to be more law-abiding. We shall address later in Chapter 7 in our discussion of a caring defendant.

Case Study 1.2 APPLE THIEF PARADOX

There are two apple thieves, Thief P and Thief UP, where thief P is very productive in stealing apples and thief UP is less productive. The apple orchard owner, Mr Owner, has an ample garden but each season the thieves consistently steal 100 apples. Thief P obtains 90 and Thief UP only receives 10 apples. Eventually, Thief UP approaches Mr Owner, revealing their identities provided Mr Owner agrees to a rule: both thieves would be allowed to collect as many apples as possible in an hour, and desist from stealing for the rest of the season. The thieves agree and proceed to collect as many apples as before, 100. If Thief P shares 10 per cent of his total with Thief UP then Thief P collects 90 apples receives 81 apples, and Thief UP receives 19 apples, 10 collected and 9 from Thief P. Mr Owner is no worse off in terms of number of apples lost, but is no longer required to invest in security and anti-theft measures. Apple Thief P’s utility from 81 ‘lawful’ apples collected under the rule is greater than the utility from 90 ‘unlawful’ apples with a probability of detection and legal sanction. Paradoxically, it is Thief UP who gains 19 apples, 9 more apples under the rule. His self-interest is maximised under the rule, as he persuaded or ‘captured’ both Thief P and Mr Owner to agree to the rule. Intelligent thieves like Thief UP might promote their interests by not following the golden principle. They fool others into believing that they would.

In the case of the Apple Thief Paradox, a fact-finder would be concerned with the market equilibrium for a private good and proceed to simplify the analysis by ignoring any specific taste Thief P has for helping the other thief and the orchard owner (Margolis, 1982). However, Thief P’s altruism now takes the form of giving apples to Thief UP. This transaction does not enter
the market, rather Thief UP, the enriched recipient of the apples, enters the market, and it is his preferences that are of interest to the economics of the paradox. If Thief UP does not enter the market but Thief P’s preference map incorporates the demand for apples to give to Thief UP, then the political economy of Thief P’s action would be of interest to the fact-finder.

To avoid legal sanctions, for example, Thief UP could fool others to agree to the sharing rule identified in Case Study 1.2. The issue is whether a rule ‘do not steal’ would be respected by all, so that nobody steals apples. Conversely, self-interested thieves establish a maxim: if you want Mr A to steal from you, then you steal from Mr A. It is universally adopted. The challenge for the law is to justify the two rules or maxims so that what one ought to do, and what one believes should be done can be reconciled in any dispute. But despite the contradictions that affect the exercise of reason, the law must abide to ensure that what a reasonable person ought to do, is acted upon.

Adapting Kant’s (pp240-5) perfection of moral law in his Critique of Pure Reason we conclude that performance of the law is about conforming with law from respect for the law. Respect, negatively defined in the Critique of Judgement as ‘the feeling of our own incapacity to attain an idea which is a (moral) law for us’ (Chalier, 2002, p97), is a key factor. Both thieves and indeed the orchard owner agreed to a rule so that irrespective of who finally collects the most applies, and thus wins, each thief had been given an equal opportunity to win. Indeed the rule invoked by Thief UP is Rawls’ maximin rule: select a rule in which the worst outcome is nonetheless better (19 lawfully acquired apples) than the worst outcomes of all other possible rules (10 apples as thieves, and probability of being caught and punished by the law). Intuitively, it is a rule that affords an opportunity for everybody to play in a game, and thus embed respect for the rule of law.

GOVERNANCE GROUPS: G-GROUPS

People belong to groups (Hargreaves and Zizzo et al, 2009). Earlier, Olson (1965) had argued that groups form around a collective action problem. The results from the experiments conducted by (Hargreaves and Zizzo et al, 2009) on artificial groups provide some useful insights into the ways that groups can be positive and negative. Overall, and in marked contrast with the literature, their experiments suggest that the presence of groups is ‘at best neutral and maybe negative in terms of welfare’ (pp322). The governance groups in this Chapter influence the laws, regulations, norms and standards that define a political economy, its citizens and its voters, its defendants and plaintiffs. If a
governance system — the political and legal system — is implicated in the creation and reproduction of systematic inequalities of power, of wealth, income and opportunities, it will rarely enjoy sustained legitimation by groups other than those whom it directly benefits. A key factor in understanding the rationale for our G-group is not to be found in Adam Smith’s ‘special pleasure of mutual sympathy’ nor in neurobiological evidence that being a member of a group produces an endorphin rush, (Dunbar, 2006), but rather in the control of the political and legal governance of a political economy.

A G-group has economic power. Economic power is a divisible and scarce resource. It is fundamentally linked to the redistribution of income and the manipulability of the economy. Our task is to unravel a set of circumstances under which the citizenry in an economy confer legitimacy, that is, circumstances under which citizens make political action decisions because they think them right, correct, justified or worthy. This may help to explain respect for the law.

Schumpeter (1942) assumed that voting entails a belief that the political system or the political institutions are accepted; that is, legitimated. He had argued that democracy per se as a political regime is important because it legitimates the position of authority. However, scholars are now of the opinion that Schumpeter’s concept of legitimacy failed to distinguish between different grounds for accepting or complying with the political system or the institutions. McNutt (1996) doubted whether participation by voting should be equated with legitimacy at all. A political system, through time, creates the conditions of its own legitimacy, (Held, 1987).

The purpose of our discussion here is to raise a difficult question and to provide an answer in the form of a paradox. Namely, are economies susceptible to resource manipulation? And if so, what is the implication for redistribution and the law. To assess the implication for redistribution, it is imperative to focus on different income levels as a channel through which the governance regime may affect the allocation of resources. The genesis of our approach is in the interpretation of income levels as bestowing command over the distribution of economic and legal resources. Simply, income equates with power, economic power. Historically, as economies evolve, particular (income) groups prosper with the security of property rights and the legal enforcement of contracts. The enclosure movement in sixteenth-century England is a case in point. Of the many characteristics that ‘bundle’ into a democracy, it is the right to vote, that many scholars attribute to democratic regimes, with less of an emphasis on the law and the promulgation of the law.
A Power Function

A tail axiom and a power function are introduced in order to capture the fact that a transfer of resources may not achieve the same outcome as a redistribution of resources. Income groups \(F_H, F_L\) are ranked in order of highest income, the higher-income groups, \(F_H\) are assumed dominant over lower-income groups, \(F_L\) because they have access to and control more wealth and are better represented and are more mobile as a population group.

While there is little hard *unequivocal* evidence in the literature on whether it is the prosperous groups that demand democracy and changes in the law or whether democracy and changes in the law foster prosperity, the *realpolitik* should be centred on groups of citizens and their respective political action decisions in terms of enacting new law and its enforcement, (Osmani, 1994). The higher-income groups, \(F_H\), base their political action decision on private information and on economic power and will only demand change in the governance regime, if change *directly benefits* them. Indeed, if the high-income groups cannot block change (through being outvoted in the democratic process or by revolution) they, being the most mobile, can choose to leave, taking their capital with them. This can then lead the economy onto a lower growth path in a manner inimical to the interests of those who instigated change. The existence of an outside option for the \(F_H\) group may temper the degree to which they are willing to resist change. One could argue that it was the length of time that the Afrikaners were in Africa that made them less mobile and, hence, more likely to resist change through the laws of Apartheid over a longer time period.

In discussing transfer and redistribution, it is imperative to define distribution from the tail as an axiom, that is, if the income groups at the tail of a distribution associate economic power with the resources, a power function is useful to capture the (welfare) transfer of the resources. This embeds the power function on normative grounds, as there will be — inevitably with a redistribution policy — an exchange of resources from one group to a second group and new laws introduced. Director’s Law, insofar as it is tractable, argues that the direction of redistribution in a democracy is from the tails of the distribution to the median; in a policy space this would translate into a rich-to-poor transfer. While the Meltzer-Richard hypothesis, arguably, would support the Law, one could infer from the hypothesis that unless a majority of voters’ income is less than the median income, political action on redistribution may not occur. Closer examination of that hypothesis elucidates a concern that should be of particular relevance to developing economies *viz* that there may be resistance from the income groups at the tail.
of the distribution to any transfer or any change in the political system that may lead to transfers.

If income groups at the tail succeed in frustrating redistribution policies and block any transfer, they are said to have economic power. Consider Figure 1.1. F(y*) individuals have y* income, but underpinning the y* is command over the redistribution of the economic resources, economic power. Economic power is enshrined in the law. The economic power environment at the tail is preferred by the F(y*) group who directly benefit from the degree of income inequality as described by F(.). To capture this more compactly, we can establish a power function, P, if we ascribe

$$P = P(y^*, \psi) = 1 - \exp[-x/\psi]$$

the power function can be illustrated as in Figure 1.2 and as more resources are redistributed away from an F(y*) group, economic power declines and declines exponentially.

If we assume that redistribution is a zero-sum game and admit to an element of conflict in the redistribution of resources, we may be able to harness the meaning of y. Power is embedded within the law and a voluntary transfer of resources will occur in the absence of the law and it is likely that a transfer of resources may not achieve the same outcome as a redistribution of resources. For example, income tax law is necessary to ensure an optimal redistribution of resources from F_H to F_L. The latter outcome is imposed by a
third-party Leviathan whereas a transfer is assumed to be voluntary. In other words, given any two end states \( x' \) and \( x'' \) it is possible that \( x' \) may welfare dominate \( x'' \) but that \( x'' \) may transfer dominate \( x' \). By transitivity, we are then back to where we started — in the state \( x \) before redistribution. The objective is to try to establish a social welfare function, \( R \), which given individual rankings will produce an Arrovian social ranking \( R = f(R_1, ..., R_N) \).

This amounts to an impossibility theorem-type situation. However, a tail axiom would dictate that any \( F(.) \) group may indeed prefer \( x'' \) because \( P(x'', \psi) > P(x', \psi) \) regardless of the welfare gains accruing at state \( x' \). \( P \) is a cardinal mapping, such as \( P(x,i) > P(y,j) \) reads as follows: ‘I am more powerful today than yesterday or you will be more powerful than me tomorrow’. This is a level comparability condition. It would suggest that any redistribution of resources is fundamentally interpersonal and by analogy, inter family and inter country. Hence, individual groups may secure a final bargaining outcome by recourse to the tail axiom, that is, by recourse to computing how much economic power is relinquished in achieving a welfare dominant outcome, and if the amount is large or indeed larger than anticipated, the redistribution policy may not take place and the momentum for change in the governance regime may disappear. An axiom of dominance such that \( \forall x' \) and \( x'' \in X, x' > x'' \Rightarrow x'D x'' \), can be generalised into a dominance condition: \( \forall i x'D_i x'' \Rightarrow x'Dx'' \) and \( \exists i \) such that \( x'D_i x'' \) & \( \exists k \) such that \( x''D_k x' \) then \( xIx'' \). In other words, the group initiating the change may realise that change is not Pareto-improving (from their perspective). With zero political action, the law will remain unchanged.
Change in Legal Regime

Embedded in the tail axiom, therefore, is the issue of dominance of income groups. Their dominance can be assured by the law. For example, as ranked in order of highest income, the higher-income groups, $F_H$, are dominant over lower-income groups $F_L$, because they control more wealth and are better represented (Ng, 1979), and are in a position to determine the law. In a different context, Borooah and McNutt (1995) had examined the role of leadership, in particular a change in leadership in securing an election winning strategy for a political party, and Kenny and McNutt (1998) had argued for a change in political regime.

![Figure 1.4 Transfer function](image)

By analogy, what is proposed here is a change in the law. In each case, the existence of a unique equilibrium is sensitive to the exact distribution of preferences; in this chapter we argue that the existence of an equilibrium is sensitive to the distribution of preferences over the pairings ($F_H, F_L$). So either we could opt for weakly separable utility function, (Borooah and McNutt, 1995), or a transfer function as a 1:1 and onto mapping from an ex-ante governance space to a new (ex-post) governance space. We opt for the latter.
A Legal Topology on Economic Power

Following the topology in Borooah and McNutt (1995) which interprets change as a partition of the space, the ex ante governance space is partitioned by change in the law. The governance space $P^*$ is the ex ante state and $P_{\sim}$ is the new ex post governance space. For example, $P^*$ represents a pre-election with political parties promising a change in the law or law ex ante and $O = P_{\sim}$ represents an x-law. The location of cohorts of income groups as subsets in $P^*$ is exogenous. Our point of departure here is that a change in the governance space spans a new subset $L'$ and that $L'$ partitions the space $P^*$. We define a partition of $P^*$ as a set $L'$ that divides $P^*$ into exhaustive and disjoint subsets:

$$L = \{L, L', \ldots \}$$

An analogy arises between $L$ and the coalition structure of the political science literature, Schofield (1993), particularly if we refer to $L, L'$ as 'regime coalitions' and interpret a subset $L$ to represent that $F_{\sim}$ group who opt to change the governance system and its laws. Our objective is to evaluate how income groups, $F(.) = (F_H, F_L) \subseteq F(.)$ as voters, rank order the alternative regime subsets. In particular, since $L'$ represents a change in regime, it is imperative that we correspond $L'$ to an electoral (winning) strategy, particularly for the group, either $F_H$ [by election and change in the law] or $F_L$ [by revolution or disobeying the law] precipitating the change in the governance regime.

From the $P^*$ space we move to the 'performativity of law outcome' space $O = P_{\sim}$, which contains a family of income-group subsets contingent on the median voter outcome. We require a mapping from $P^*$ to $O$. Since $P^*$ is a non-empty compact, convex set, for any $p \in P^*$ we could define such a mapping as $m = f(p), \forall p > 0$, for a fixed value of $p$. The range of images of $p$ under $f$ is a probability distribution of citizen preferences that could be represented by a weakly separable transfer function. We have to allow for a mapping from $P^*$ to a probability distribution of income-group subsets' preferences to the outcome space $O$. We suggest that the transfer function is the mapping from $P^* \to O$, which raises the issue of equivalence. In other words, we have targeted a subset $L' \subseteq P^*$ and our aim is to show that there is a continuous mapping from $L'$ to an equivalent subset $O'$ in $O$-space. We have to show that the sets $P^*$ and $O$ are equivalent and in order to do this we need a 1:1 function, $h$, from $P^*$ onto $O$. This has been proved elsewhere by McNutt (1992b) that a vote function is $h$, if the vote function is 1:1 and onto. As the transfer function is the mapping from $P^* \to O$, then, the transfer function is
the 1:1 function, h, from P* to O. Therefore the sets P* and O ≡ P~, are equivalent. Intuitively, the F_H group must map into the O' subset, for governance change to occur.

A Paradox: Conspiracy of Equality

Remember that the \textit{ex ante} governance space is partitioned by change in the governance regime. The existence of an O' subset leads to a political action decision $\beta \in L' \subseteq P*$. So either the F_H or the F_L group will initiate the governance change, by enacting new law, by voting in general election or by revolution and observed dismemberment of the law. The actions constitute the political action decision. However, the identity of the F_H group may vary from regime to regime, thus while a particular regime may have a majority of "types" — of like-minded individuals — in the F_H income groups considered individually, the individual types comprising that majority may vary across the regimes. Furthermore, if the outcome space, O, incorporates a median in all directions across voter preferences, the possibility of an unstable P~ may arise. So a particular F_H may lose out from a change in governance regime since the outcome is sensitive to the exact distribution of F_H type preferences.

It is therefore imperative for any F_H group or F_L group provoking the change that there be correspondence between their respective equilibrium strategies and (any) Condorcet majority winning strategies. In other words, the F_H group may be in a position to influence the utility differential and thereby their electoral chances of remaining F_H types by altering the contents of their political agenda to match F_H concerns, for example, property rights, criminal justice system; and paradoxically, the F_L group may be in a similar position to influence the utility differential and thereby their electoral chances of becoming F_H types by altering the contents of their political agenda to match F_H concerns, for example, minimum wage legislation, victims' rights, better education, health provision, housing. The contents are characteristically different and as a consequence F_H and F_L as voters may cast mistaken votes if the new law is voted on, McNutt and Kenny (1998b).

Therefore, with dominance and invoking the tail axiom, F_H groups under P* will map onto F_H groups under P~ and F_L groups under P* will map onto F_L groups under P~. For the F_L group the mapping is from O' onto L' and for the F_L group the mapping is at least into the compliment of O', in Figure 1.4. Since the F_H groups tend to have greater political representation, the tail axiom evokes a more powerful interpretation. Should ever the F_H groups realise that command over economic resources is better protected or secured under a change of governance regime, O \equiv P~ will obtain. This is the demand
for democracy that many refer to in the developing economics literature. In more advanced economies it refers to a change in the law. However, guarantees on any bundle of characteristics in the (ex post) $P_\sim$ regime are a non-rival and non-excludable public good obtained without the law. If neither the $F_H$ nor $F_L$ groups do not obtain a Pareto improvement from $P^*$ to $P_\sim$, a change in governance will not occur. In other words, the mapping must be from $O'$ onto $L'$ for new law to exist.

**Embedded Law**

Law is embedded in the political system. In any political system there is a hierarchy of income groups, $F(\cdot)$, and subsets of the groups, $(F_H F_L) \subseteq F(\cdot)$, may fare better or worse with a change in governance regime. Our topology compactly demonstrates that individual groups in the *ex ante* governance regime may not, within a degree of probability, map into a similar income group. A manipulable political economy obtains when at least one $(F_H F_L) \subseteq F(\cdot)$ group is capable of manipulating resources to affect the way the economy behaves in an attempt to bring about a more preferred outcome. A plausible inference is that ‘a manipulable economy will exhibit chaos in its development path’ (Barnett et al, 1989) or that the law and changes to the law may end up simply as protecting the contracts and property rights of the $F_H$ groups or as a disincentive to non-compliance with the law. If we generalise this across the $F_L$ groups, our contention is that governance change may occur by revolution or overthrow of the existing governance regime and that governance change – measured by new laws and amendments to existing laws – will coincide with observed disseverance of the law. If we generalise this across the $F_H$ groups, our contention is that change may not occur unless the change directly benefits the $F_H$ group.

Paradoxically, if one group from the pair $(F_H F_L) \subseteq F(\cdot)$ could initiate a change in governance for the other group to vote on or not, both would not vote for a regime change. This is a classic prisoners’ dilemma result. While the policy implications of the dilemma could explain inaction on redistribution policies in any economy, it does proffer a testable hypothesis of political stasis in many developing economies. The topology would also suggest that action in law should be interpreted as a family of income group coalition response to observed disobedience and should be modelled as action decisions based on a (private) power function. The analysis presented in this chapter reinforces the argument that a change in the law enjoys sustained legitimisation by groups whom it *directly benefits*. If those groups continue to command economic resources and influence the direction of the law,
undemocratic political action and dissonance of the law will persist at a deadweight cost to society.

Greater inequality bestows more power to the higher-income groups and it is their political action decisions that are a crucial link connecting the type of legal regime with economic growth. These conclusions should suffice to dispel the notion that if the law is universally disobeyed by FL groups that the case against inequality has been decisively won. Law is obeyed by a random individual if it directly benefits that individual; however, because it benefits an individual does not guarantee that the law will be obeyed. Hence there is an underlying morality that might help to distinguish economic-centric and person-centric approaches to adherence and compliance. Unequal distributions can exist if supported by a morality of redistribution and social justice. It is reminiscent of Pope Leo XIII’s prescience in *Populorum Progressio* in pointing out that encouraging ‘the poor man’s envy of the rich’ is not an adequate way to address the social question.

Specific G-groups, high-income and professional, form a social bond the benefit of which is to preserve their status and ranking in the G-grouping. For example, there is general consensus that current medical malpractice system in the US does not work effectively either to compensate victims fairly or to prevent injuries caused by medical errors. Policy responses can often lead or not to effective reforms and whether policy works or not will depend on the rent-seeking in the G-groups including lawyers and legal fraternity, malpractice insurance companies, medical care and government activity.

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**Case Study 1.3 F_H AND THE PANTS SUIT**

An interesting case Pearson v Chung happened in Washington DC in 2007. Known as the pants suit case, a judge sued his dry cleaners for $54m for allegedly losing his trousers. A sign at the shop promised ‘satisfaction guaranteed’. The plaintiff was not satisfied, so he cried fraud. He then used his knowledge of the law to calculate the damages he was owed. When the case was dismissed after two years of litigation, many felt justice had prevailed. But the defendants had to endure a lengthy legal process, damage to their business reputation and a legal fee of $100,000. They had considered emigrating back to their home country but were persuaded by friends to stay.
In New York City there are more than 60 bureaucratic steps to take before a disruptive pupil can be suspended from the school. Although the pupil is in the wrong, a teacher's fear of violating a pupil's right allows the pupil to remain at the school to the detriment of the other pupils. The law is not protecting individuals from the state; it is, paradoxically, facilitating those 'in the wrong' in this case. G-groups are presented in the context of easily identifiable rich v poor as a mode of understanding political change, but in understanding the political economy of law, G-groups are presented as 'those in the right' who can harness the state's power to settle private actions or disputes.

The law is not protecting individuals from the state: it is, paradoxically, facilitating G-groups with access to the law and due legal process to harness rents from blameless people who settle baseless claims to make them go away. How can the law be neutral given the prohibitive costs of legal process and the unpredictability of juries? The ethics of duty and rights, the ethics of responsibility and obligation, imply important corrections to the perfect market paradigm that underpins the utilitarian calculus of economic analysis. Not only is the ethics of justice intertwined with the ethics of duties and rights as illustrated in Table 1.2, but the law, paradoxically, can be observed as facilitating those 'in the wrong' and call into question the fairness of procedures for deriving principles of justice.

Fidelity to Law

One may be of the view that the arguments presented in this chapter fall within the tradition that is usually termed natural law theory wherein it is argued that law cannot be properly understood except in moral terms. Although its history and its critique extends through the hundreds of years of modern philosophy from the writings of Aquinas to the present day, the 1958 Hart-Fuller debate, and the exchange of ideas between these legal minds in the Harvard Law Review, is a good reference point to understand why a dispute about the relations of law and morality would have a bearing on laws' performance. Hart had argued that the separation of law and morality is an aid to clear reasoning whereas Fuller had argued that 'when certain minimum moral qualities cease to exist in a legal system, it ceases to command fidelity; that is it ceases to have a claim to citizens' obedience' (Cotterrel, 1989, p130). For our purposes, in the Fable of the Bamboo Flute a fact-finder could resolve the dispute with reference to his own morality or by applying the law or both if sufficient information is available at the time of resolution. The Fable enables the argument that a general concept of law necessarily entails some
moral elements.

The particular emphasis within a political economy of law paradigm, however, is on the x-law where the experiences of the law in an x-law environment can influence the behaviour of a rational reasonable individual. The process of legal change as defined in terms of change in legal doctrine and forms of regulation can in part be explained by the presence of G-groups in society who can change the law directly or indirectly through non-compliance with the law. In the latter case, for example, new security and terrorist legislation has been in reaction to a G-group, the terrorist. Human rights activists, environmental lobbyists, for example, as G-groups can indirectly affect legal change. The recognition of G-groups within a political economy of law paradigm raises an interesting question — whether or not the law is G-group law-specific: in other words, when law is enacted is it enacted for the common good or for the G-group? Throughout this book we argue that a theory of law has to be concerned with behaviour not only of potential defendants and plaintiffs but also with judicial activity of deciding cases, use of legal language and the experiences of the law as observed through compliance with norms, rules and standards.

Rationality is at the core of a political economy of law paradigm. McNutt (2005) had argued that as a rational person with a Kantian sense of ethics you implicitly and inadvertently choose to balance the actual cost of doing x against the expected cost of doing y. You are a Type I individual. However, traditional cost-benefit analysis would have you balance the benefit of doing x against the cost of doing x. You are a Type II individual. Law and economics with its assessment of the whole compares the expected cost of doing x, $C^e(x)$, with the expected benefits of not doing x (Chapter 4). The expected benefits of not doing x are inversely related to the probability of detection. You are a Type III individual, and provided sufficient numbers of individuals are of Type I and II, there will always be the free-rider or the marginal thief, the agent whose decision to do ($-x$) is a function of other individuals' beliefs that to do ($-x$) is so immoral, unethical, false or untrue that no one will do or commit ($-x$), so the marginal thief or the recidivist criminal will continue to do ($-x$).

Table 1.9 Type and fidelity to law

<table>
<thead>
<tr>
<th>Type</th>
<th>Do x, iff $C(x) &lt; C^e(y)$: Otherwise Do y.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type I</td>
<td>Do x, iff $C(x) &lt; B(x)$: Always Do x.</td>
</tr>
<tr>
<td>Type III</td>
<td>Do $-x$, iff $C^e(x) &lt; B^e(-x)$: Otherwise Do x.</td>
</tr>
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</table>
Rousseau had argued in his *Discourse* on the origin and basis of inequality that if a group of individuals set out to take a deer they are fully aware that they would all have to remain fruitfully at their posts in order to succeed, but if a hare happens to pass near one of them, there can be no doubt that once he had caught the prey, he cared very little whether or not he had made his companions miss theirs. Each individual has a capacity for rational calculation and if cooperation is a gain for an individual then that individual will cooperate. If there is a dispute the parties can rely on negotiation in the hope of narrowing the dispute and limiting damages.

The financial economics literature has demonstrated that there is a market for traded uncertainty amongst households. And not unlike the financial model of Black and Scholes in the 1970s, law and economics is searching for a grand theorem of negotiation, obligation and commitment. Type I individuals taking precaution in a criminalised environment is something of a guess. The challenge for law and economics is putting a price on a contingent liability – something that would be exercised only if it was in the buyer’s interest to do so. So if you live in anarchy there is a price because there is a liability since in the absence of property rights you have no possessions.

In an ordered society with law and government, there is a probability of liability and loss, and in conjunction with the classical moral hazard problems, no one price on a contingent liability will prevail, so some of us take precautions and incur insurance costs as Types I and II, while others do not and continue as Type III. The situation arises as a classical prisoners’ dilemma where the individual benefits more by playing a game defectively while the others play cooperatively, but in the long run all players will play defectively, cooperative behaviour will erode and all players will be worse off.

Therefore the punishment of Type III dependent criminal persons by imprisonment or fines should translate into controlling their dominant positions, and thus ensuring that the cost of their behaviour is increasingly less of a burden on Type I and II individuals. We address this issue in the case of a tortfeasor in Chapter 4. What we suggest in Chapter 7 is the possibility of a trading exchange of an asset called ‘crime about to be committed’ between a putative defendant and a potential plaintiff at time period t before the crime is committed at time period t + T. The caring-defendant model treats the law as a social phenomenon; it recognises that often the impetus for change is not usually found in the law or by reaction to G-group lobbying but in the social, economic and political conditions in which law exists. The argument would not look out of place in empirical legal theory in its search for an explanation as to why law exists.