"RULES VERSUS COST-BENEFIT ANALYSIS IN THE COMMON LAW": A COMMENT

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To set the stage for the remarks that follow, a brief summary of Professor Rizzo's position is in order.[1] He judges a legal system to be superior if it is policy-neutral (does not impose a particular hierarchy of ends on society) and if it facilitates the attainment of individual, private goals. If it is based exclusively on abstract rules, Professor Rizzo asserts that a system of common, judge-made, private law represents such a superior legal system. By way of contrast, he rejects as being inferior, any legal system that employs cost-benefit analysis (a balancing of interests). To develop his argument, Professor Rizzo makes use of the common law of torts. For the assignment of liability in this field, he favors the application of a strict liability rule, rather than negligence systems that require the use of cost-benefit analysis.

Although I accept Professor Rizzo's position concerning the proper role of a legal system, I question certain aspects of his analysis. To illustrate the importance of the deficiencies in Professor Rizzo's analysis, we can turn to the common law of contracts. The instrumentality used to assign liability in breach of contract cases is not cost-benefit analysis. Instead, a strict liability rule is applied.[2] Thus, for liability to be imposed on a breaching party, a victim of a breached contract does not have to prove that the cost to him exceeds the benefit to a breaching party.

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[1]Rizzo (1985).

[2]There are exceptions to this statement, but they are extremely rare. For example, contracts can be discharged because of lack of consideration, mutual mistake, fraud, incapacity, duress, and impossibility.

It appears that the assignment of liability in breach of contract cases conforms to the requisites of a rule-driven, common law system that is devoid of cost-benefit analysis. But, this is not the case. Even though cost-benefit analysis is not employed at the time when liability is assigned, it is an integral part of the common law of contracts. For example, the strict liability rule is used in contract law because a breaching party can prevent or insure against a breach at a lower cost than can a victim. Given this cost-benefit calculus, which is based on standard, economic efficiency criteria, the strict liability rule provides an effectual and efficient means of assigning liability.[3] To put it another way, the strict liability rule is nothing more than the instrument used to administer a system of law that is driven by cost-benefit analysis.

After liability is assigned in breach of contract cases, the proper remedy must be determined. The common law of contracts employs two remedies. The most common remedy requires the breaching party to pay damages to the victim of a breach, where the damages are equal to the victim's lost profits. However, for certain cases (real estate transactions and others that involve the transfer of "unique" goods), specific performance is required.[4] The choice of the appropriate remedy depends on the direct application of cost-benefit analysis.

In most cases, the application of cost-benefit analysis reveals that a specific performance remedy would create economic waste. For example, when a victim's lost profits from a breach are less than the net costs to the breaching party of performing a contract, it is wasteful to require specific performance. In these cases, the common law of contracts (the application of cost-benefit analysis) promotes economic efficiency by allowing a breaching party to discharge his obligations by paying a victim damages. This remedy leaves a victim as well off as if a contract had not been breached, while it leaves a breaching party better off than if a specific performance remedy would have been required.[5]

[3]In the context of Professor Rizzo's paper, it is important to mention that Professor Posner (1977) demonstrates that common, judge-made, private law has evolved in a spontaneous way, and that it is driven by a cost-benefit calculus that is based on standard, economic efficiency criteria.

[4]See Rubin (1981).

[5]It should be mentioned that a breach will not occur, even when a potential breaching party anticipates losses from the performance of a contract, in those instances when a potential victim's losses from a breach are anticipated to exceed the net costs to the potential breaching party of performing a contract.

The specific performance remedy is reserved for those cases in which it is impractical to apply cost-benefit analysis. For example, when contracts involving real estate or "unique" goods are breached, it is difficult to determine a victim's damages because market prices systematically understate a victim's losses.

Unlike the assignment of liability in breach of contract cases—where the application of a single rule yields results that are consistent with the direct application of an efficiency-based, cost-benefit analysis—a single rule for the determination of remedies is inappropriate. To maintain consistency between an efficiency-based, cost-benefit analysis and the instrumentality chosen to administer the law, the common law of contracts allows for two possible remedies for breached contracts. The choice of the appropriate remedy depends on the direct application of cost-benefit analysis.

The common law of contracts reveals serious shortcomings in Professor Rizzo's analysis. Without cost-benefit analysis, how would we be able to know whether a strict liability rule is or is not a superior way to assign liability in breach of contract cases, or how would we be able to determine whether a damage payment or specific performance is the appropriate remedy for discharging liability for a breached contract?

By rejecting cost-benefit analysis, Professor Rizzo fails to provide a means to determine the appropriate instrumentality for administering the law. In consequence, Professor Rizzo is left in an untenable position, since he has no way to determine whether one abstract rule is superior to another; without cost-benefit analysis, all rules must be assumed to be equally desirable.[6]

Rules (instrumentalities used to administer the law) and cost-benefit analysis are not mutually exclusive; they are necessarily related. Therefore, contrary to Professor Rizzo's assertions, the fundamental issue is not a choice between rules and cost-benefit analysis. Rather, it is the determination of the appropriate criteria that should be used to guide cost-benefit analysis.[7] In the final analysis, Professor Rizzo's failure to address the issue of cost-benefit criteria represents the fatal flaw in his argument.

References

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[6]It goes without saying, that, by rejecting cost-benefit analysis, Professor Rizzo also fails to establish a means to determine when rules do and do not provide appropriate instrumentalities for administering the law.

[7]For a summary of some of the cost-benefit criteria that could be used, see Bowles (1982, pp. 47–52).

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THE FTC AND VOLUNTARY STANDARDS: MAXIMIZING THE NET BENEFITS OF SELF-REGULATION

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The vast majority of commercial transactions work well, without need for interference of any kind. In some cases, however, the market "fails," and regulation of some kind is warranted. But this need not be *government* regulation if industry self-regulation is superior. In this article I explain the theoretical reasons self-regulation may be superior to government regulation, give some examples of areas where self-regulation is currently working, and discuss the potential antitrust pitfalls involved in self-regulatory activities.

Theoretical Advantages of Self-Regulation

Private sector solutions will frequently be superior to the alternative of government intervention, for several reasons. First, self-regulation directly involves the parties who will generally have the best institutional knowledge about the need for action and about the efficacy of various potential actions. Although government can always hire the technical expertise needed to draft complicated regulations, it will almost always be slower in perceiving the need for some action than will the participants in the relevant market.

Second, self-regulation is more flexible, and therefore is less likely to stifle innovation or excessively limit consumer choice. That is, once the government promulgates a regulation, it is more or less permanent. One of the most difficult challenges the administration has faced is changing existing rules. Old rules tend to acquire

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