DISSERTATIONS IN

SOCIAL SCIENCES AND BUSINESS STUDIES

OSKARI JUURIKKALA

Essays on Psychology and Morality in Economic Analysis of Law

PUBLICATIONS OF THE UNIVERSITY OF EASTERN FINLAND
Dissertations in Social Sciences and Business Studies

UNIVERSITY OF
EASTERN FINLAND

Essays on Psychology and Morality in Economic Analysis of Law

Dissertations in Social Sciences and Business Studies No 40

OSKARI JUURIKKALA

Essays on Psychology and Morality in Economic Analysis of Law

Publications of the University of Eastern Finland
Dissertations in Social Sciences and Business Studies
No 40

Itä-Suomen yliopisto
Yhteiskuntatieteiden ja kauppatieteiden tiedekunta
Joensuu
2012

Print: Kopijyvä Oy
Joensuu, 2012
Editor: Prof. Kimmo Katajala
Sales: University of Eastern Finland Library

ISBN (bind): 978-952-61-0741-7
ISSN (bind): 1798-5749
ISSN-L: 1798-5749
ISBN (PDF): 978-952-61-0742-4
ISSN (PDF): 1798-5757

Juurikkala, Oskari
Essays on Psychology and Morality in Economic Analysis of Law, 225 pp.
University of Eastern Finland
Faculty of Social Sciences and Business Studies, 2012
Publications of the University of Eastern Finland,
Dissertations in Social Sciences and Business Studies, No 40
ISBN (bind): 978-952-61-0741-7
ISSN (bind): 1798-5749
ISSN-L: 1798-5749
ISBN (PDF): 978-952-61-0742-4
ISSN (PDF): 1798-5757
Dissertation

ABSTRACT

There is nothing more practical than a good theory. This thesis is a compilation of essays that seek to improve our understanding of law by building on new developments in economic theory, focusing on the role of psychology and morality in economic analysis of law. Essay 1 applies behavioral economics to financial regulation, challenging the notion that bounded rationality of investors implies more regulation. It argues that debiasing regulations need not be intrusive; that faulty market perceptions are best corrected through market-based solutions; that overregulation tends to cause lack of market discipline, pricing inefficiencies and problematic innovations; that regulators are also subject to imperfect rationality; and that regulatory complexity exacerbates the harmful effects of bounded rationality. Essay 2 elaborates the notion of behavioral paternalism in the context of consumer credit regulation. It finds that many aspects of existing regulations in the EU and the US are best understood through the lens of behavioral paternalism, and that there are many possibilities for further regulation along these lines. Essay 3 explores the role of social norms and moral motivation in legal and regulatory policy. It demonstrates that there are several practical ways in which these non-legal norms can be taken into account in order to improve the quality and effectiveness of lawmaking. Essay 4 develops a novel theory of economics based on the classical theory of virtues. It finds that virtues play a major role in the functioning of economic systems, and that optimal legal design depends on the level of virtue of the citizens.

Keywords: behavioral economics, behavioral law and economics, financial regulation, paternalism, social norms, ethics and economics, virtue ethics

Juurikkala, Oskari
Esseitä psykologiasta ja moraalista oikeustaloustieteessä, 225 s.
Itä-Suomen yliopisto
Yhteiskuntatieteiden ja kauppatieteiden tiedekunta, 2012
Publications of the University of Eastern Finland,
Dissertations in Social Sciences and Business Studies, No 40
ISBN (nid.): 978-952-61-0741-7
ISSN (nid.): 1798-5749
ISSN-L: 1798-5749
ISBN (PDF): 978-952-61-0742-4
ISSN (PDF): 1798-5757
Väitöskirja

ABSTRAKTI

Ei ole mitään käytännöllisempää kuin hyvä teoria. Tämä esseekokoelma pyrkii parantamaan ymmärrystämme oikeudesta hyödyntämällä taloustieteen uusia virtauksia, keskittyen psykologian ja moraalin rooliin oikeustaloustieteessä. Essee 1 soveltaa psykologista taloustiedettä rahoitusmarkkinoiden sääntelyyn haastaen käsityksen, jonka mukaan sijoittajien rajoitettu rationaalisuus edellyttää sääntelyn lisäämistä. Psykologisia vääristymiä korjaava sääntely voi olla luonteeltaan kevyttä; virheelliset markkinakäsitykset korjautuvat parhaiten markkinapohjaisilla ratkaisuilla; ylisääntely johtaa usein markkinakurin heikkenemiseen, epätäydelliseen hinnoitteluun ja ongelmallisiin rahoitusinnovaatioihin; sääntelijät ovat myös epätäydellisesti rationaalisia; ja sääntelyn monimutkaistuminen pahentaa rajoitetun rationaalisuuden aiheuttamia haittoja. Essee 2 kehittää psykologiseen taloustieteeseen perustuvaa paternalismin teoriaa kuluttajaluottomarkkinoiden sääntelyssä. Sen mukaan monet nykyisen sääntelyn ominaisuudet Euroopassa ja Yhdysvalloissa selittyvät parhaiten psykologisella paternalismilla; näkökulma tarjoaa myös runsaasti mahdollisuuksia sääntelyn kehittämiseen. Essee 3 selvittää sosiaalisten normien ja moraalisen motivaation merkitystä oikeuspolitiikassa. Se osoittaa, että nämä ei-oikeudelliset normit voitaisiin ottaa monin tavoin huomioon lainsäädännön kehittämiseksi. Essee 4 kehittelee uutta, hyveisiin perustuvaa taloustiedettä. Hyveet osoittautuvat tärkeiksi talouden toiminnan kannalta, ja optimaalinen oikeuspolitiikka riippuu kansalaisten hyveellisyydestä.

Asiasanat: psykologinen taloustiede, psykologinen oikeustaloustiede, rahoitusmarkkinoiden sääntely, paternalismi, sosiaaliset normit, moraali ja talous, hyve-etiikka

Foreword

Life tends to be funny. Even when it is not, it is an adventure. I had serious doubts about starting a PhD, but I ended up enjoying it tremendously.

This thesis was inspired by the conviction, phrased by the psychologist Kurt Lewin, that there is nothing as practical as a good theory. Economists also know that there are few things as dangerous as bad theories.

I am especially grateful to Samuel Gregg (for encouraging me to pursue the academic vocation, despite everything), Jason Lepojärvi and Varro Vooglaid (for reigniting my faith in the power of ideas), Jude Chua Soo Meng (for his childlike ability to take delight in truth for its own sake), and my supervisor and dear friend Kalle Määttä (for his unfailing guidance and enthusiasm; and for insisting – I will never forget that phone call).

From the University of Helsinki, I wish to thank especially Pia Letto-Vanamo (for welcoming me so warmly to the research community at KATTI) and Raimo Siltala (for teaching me to read and think scientifically). For helpful conversations along the way, I am also grateful to Lauri Ahokallio, Klaus Alholm, Niclas Berggren, Thomas Brand, Peter Boettke, Philip Booth, Eric Crampton, Martin Estlander, Matias Forss, Joshua Hall, Ilkka Harju, Sakari Huovinen, Klaus Ilmonen, Esa Jokivuolle, Teemu Juutilainen, Ville Kaikkonen, Nils Karlsson, Eero Kasanen, Jussi Kivistö, Antti Kuusterä, Carl Löfberg, Jaakko Mikkilä, Kalle Mikkola, Tomas Munzi, Jukka Mähönen, Sami Napari, Kristian Niemietz, Sakari Puisto, Pertti Pylkkönen, Luis Ravina, Juha-Pekka Rentto, Cornelius Schaub, Daniel Schwarcz, Alejo Sison, Jussi Syrjänen, Juhani Vaivio, Martti Vihanto, Seppo Villa and Charles Whitehead. There are many others I must have forgotten to mention.

A special thanks goes to Vesa Kanniainen and Matti Heimonen for their swift and excellent work as pre-examiners.

For financial assistance, I also wish to acknowledge the generous support of Emil Aaltonen Foundation, the Finnish Cultural Foundation, Suomen arvopaperimarkkinoiden edistämissäätiö, Yrjö Jahnsson Foundation, Liikesivistysrahasto, Acton Institute, and the University of Helsinki.

The last and the biggest thanks goes to my love and my all. Without you, I would be nothing. Without your love, I would cease to be. (Quite literally.)

Helsinki, 26 March 2012

Oskari Juurikkala

Contents

1 INTRODUCTION 9
1.1 Economics in Turmoil 9
1.2 Models vs. Realism 10
1.3 Rationality and Rational Behavior 11
1.4 Freedom vs. Paternalism 11
1.5 Individual, State, and Society 12
2 OBJECTIVES AND METHODOLOGY 13
2.1 The Big Picture 13
2.2 Methodology 14
2.2.1 The Challenge of Normativity 14
2.2.2 Evaluating Models and Theories 16
2.2.3 Theory Development: Inductive and Deductive 20
2.2.4 Technique and Precision 21
3 RESULTS AND REFLECTION 23
3.1 Essay 1: Behavioral Economics and Financial Markets 23
3.1.1 Objectives and Exclusions 23
3.1.2 Contributions 24
3.1.3 Limitations and Further Research 26
3.2 Essay 2: Behavioral Paternalism in Consumer Credit Regulation 28
3.2.1 Objectives and Exclusions 28
3.2.2 Contributions 29
3.2.3 Limitations and Further Research 30
3.3 Essay 3: Social Norms, Morality, and the Law 31
3.3.1 Objectives and Exclusions 31
3.3.2 Contributions 31
3.3.3 Limitations and Further Research 32
3.4 Essay 4: Law and Virtue 32
3.4.1 Objectives and Exclusions 32
3.4.2 Contributions 33
3.4.3 Limitations and Further Research 34
REFERENCES 35
ESSAYS 38

1 Introduction

"To regulate or not to regulate, and if to regulate, how? These are the questions." – These were the first words of one doctoral dissertation some 15 years ago (Määttä, 1997: 1). They provide an excellent summary of one of the principal questions of normative economic analysis of law, and they crystallize the basic question of the present dissertation, too: *How can we improve law and regulation?*[1]

Those are, of course, huge questions. Any piece of research can only try to give a very partial answer to them (in fact, Määttä's dissertation was concerned with environmental taxes). In this overview, I discuss the broader motivation, objectives and methodology of the present dissertation, and outline its principal results.

The essays contained in this dissertation were motivated by a wide range of observations and concerns. These are discussed next in order to draw out the common themes reflected in the essays. The essay topics were chosen in such a way as to highlight different yet closely related facets of the broader normative question.

1.1 ECONOMICS IN TURMOIL

One of the leading motivators of the research project was the state of modern economics. While economics, like any field of science, has always been subject to methodological debates, it seems to be accurate to say that economics has rarely undergone such lively discussions on its very foundations as it is doing today. There are numerous reasons for this, many of which I cannot go into here, but there is one which was especially pertinent during the making of the dissertation, namely the so-called Global Financial Crisis (GFC).

The GFC started in summer 2007 and became increasingly dangerous through 2008 and 2009. According to some views, the present macroeconomic instability is just another phase in the unfolding of the same, larger chain of events. The crisis was a practical, real-world event, but it raised numerous questions about the theory of economics, finance, law, and regulation.

In terms of economic theory, one of the big questions was: *Is economics to blame for the crisis?* Many commentators both inside and outside academia argued that the crisis had been caused by bad economics, although others

[1] I am using the terms "law" and "regulation" broadly synonymously, not limiting the latter to so-called regulatory law. There is, however, at least a difference of nuance. See Baldwin and Cave (1999: chapter 1) for an extended discussion, with which I concur.

defended the role of economics and attacked faulty government regulation and monetary policy instead (see essay 1). It may be that both were partly right, as one argument does not necessarily exclude the other. Regardless of what the ultimate truth is, the crisis certainly provoked a lively debate on the foundations of economic science as well as its implications for financial law and regulation. Some argued that our macroeconomic theories were unsound and needed to be replaced by better ones (see Balzli and Schiessl, 2009; White, 2006, 2008, 2009). Others pointed their finger at microeconomics, which of course is of more direct relevance to economic analysis of law; in particular, the followers of behavioral economics argued out that the crisis proves their claims of investor irrationality (see essay 1). Still others critiqued the simplifying assumptions of modern financial theory which they held to be dangerously misleading and a root cause of faulty regulations (see Hutchinson and Dowd, 2010; Turner Review, 2009). Due to confirmation bias, however, "the lesson most people have learnt is that they were right all along" (Kay, 2011a: 7).

The essays contained here are not an attempt to provide an answer to the theoretical concerns raised by the financial crisis. Rather, they are (especially essays 1 and 2) studies on the *legal and regulatory implications* of the novel challenges to the standard models of neoclassical economics. The first two essays discuss financial regulation in light of behavioral economics, and many of the examples used in these essays are inspired by the financial crisis and its aftermath.

1.2 MODELS VS. REALISM

The ongoing debate on the foundations of economics reflects a broader concern, which is the role and realism of scientific models and, more generally, of analytic frameworks. The word *model* is sometimes used to refer to mathematically represented models, but it is equally applicable to abstract, conceptual or graphical models. One of the classical problems of the philosophy of science is what role models play in science and how they relate to reality (see generally Frigg and Hartmann, 2009).

In economics, the notion of models is especially important, because the object of economic science is extremely complex and there is an obvious necessity for simplifying assumptions. The interesting and challenging question is, what are the most appropriate assumptions, and what difference does it make if the assumptions are altered? Perhaps more importantly, should economics always adopt a deductive approach based on logical and consistent – yet evidently unrealistic – axioms, as opposed to an inductive approach that in all likelihood cannot be formalized into a self-contained model but which is better able to reflect and explain what we see happening around us (Kay, 2011b)?

The issue of models-versus-realism is an important motivating question for all the essays in this dissertation. In the first two essays (which focus on behavioral economics and financial regulation), the question is about the realism of the assumptions that we make with respect to economic agents and what it implies for regulation if we change those assumptions. The third essay is concerned with the broadening of the analytic framework used in economic analysis of law, and challenging the "legal centrism" so typical of legal (and Law and Economics) scholarship. The last essay is an original study that attempts to bring further realism to economic models by incorporating the insights of classical virtue theory into the behavioral assumptions.

1.3 RATIONALITY AND RATIONAL BEHAVIOR

One of the principal assumptions in economics is that concerning the rationality of economic actors (see Sen, 1977, 2008). The first two essays draw explicitly from the literature on behavioral economics, which challenges the ordinary neoclassical assumption of perfect rationality and replace it with the notion of *bounded rationality*. The findings of behavioral economics can be summarized as follows: (1) there are proven and empirically significant departures from the simplistic rational choice model of behavior, and (2) these departures are systematic in the sense that they are non-arbitrary and hence predictable and conformable to economic analysis (see Rabin, 1998).

The other two essays are also concerned with rationality, but from a different perspective. Whereas the behavioral economic school takes a different view of the cognitive abilities of economic agents, the rationality postulate of modern economics can be challenged in other ways, too. One of the classical issues concerns *practical rationality*, which is closely linked to philosophical questions on ethics and morality (see generally MacIntyre, 1987). Essays 3 and 4 reflect these concerns, the first drawing from the insights of research into intrinsic and moral motivation, and the second building on the notion of rationality embedded in classical virtue theory.

1.4 FREEDOM VS. PATERNALISM

A fourth common theme and motivation of the essays is the age-old challenge of freedom and autonomy versus paternalism. The notion of paternalism is discussed more explicitly in the second essay, but the theme is relevant for all the four essays, which provide different perspectives to this question.

Essay 1 presents arguments that are highly critical of the benefits of paternalism, at least in the context of financial markets. Essay 2 offers a

complementary perspective, showing that a special type of paternalism may be reasonable in the area of consumer finance. The last two essays look at the issue from the wider viewpoint of moral behavior: essay 3 argues that there is an argument for legal paternalism when this is necessary to uphold positive social norms and moral attitudes. Essay 4 presents a detailed examination of the dilemma faced by lawmakers when trying to "legislate morality".

1.5 INDIVIDUAL, STATE, AND SOCIETY

The fifth broad consideration is an upshot of the previous theme: the question is not merely that of whether, when and to what extent individual freedom should be limited, but also that of the role of the different social institutions and their interactions with each other. Sometimes political philosophy is debated in an analytical framework that reduces the issue to the dichotomy between *the individual* and *the state*, but a more realistic model has to take into account the broader reality called *society*, which is not reducible to the political authority. A realistic picture of society also acknowledges the fact that the notion of *markets* cannot be reduced to interactions among autonomous individuals, but it has to be understood in a wider context that includes law, social norms and morality (see Kay, 2004, and the references cited in essays 3 and 4).

In the first two essays, these issues are discussed only cursorily, with special reference to the role of markets and civil society in complementing state-made financial regulation, the interaction between markets and civil society is also emphasized. The last two essays are more directly concerned with the notions of morality and civil society, as they attempt to develop a theory of the role of law in building up valuable informal social institutions; they also highlight the role of civil society in influencing moral culture and moral development, ultimately influencing the law too.

2 Objectives and Methodology

2.1 THE BIG PICTURE

Given the wide nature of the fundamental questions of this dissertation, it has been necessary to narrow down the scope and focus on specific issues and perspectives. In the previous section I have already explained some of the many complementarities between the essays.

In a sense, the essays can be seen as forming two pairs. The first two essays examine the implications of behavioral economics for the theory of Law and Economics, with special reference to financial markets regulation. The last two essays discuss the role and importance of non-legal, and especially moral, forms of influence on behavior, while also trying to assess the role of law in influencing the same non-legal institutions and norms. On the other hand, it should be emphasized that, with respect to each other, these two pairs provide complementary insights to the broader questions of economic analysis of law.

More concretely, the essays advance two broad research objectives: theory development, and the making of policy proposals.

First, all the essays are principally concerned with *theory development*. The first two essays develop the theory of economic analysis of law from the viewpoint of behavioral economics. Financial market regulation serves as a limiting context, which helps to narrow down the discussion and focus on specific issues. Nevertheless, the objective is to yield results that might be generalized and applied in other contexts also (I will discuss the challenges of generalization later). The last two essays develop the theory of Law and Economics from the viewpoint of morals and intrinsic motivation; in these essays, the examples are taken from a wider range of contexts.

Second, in addition to developing the theory of Law and Economics, the essays seek to provide *policy proposals* related to the design of law and regulation. This is naturally related to the objective of theory development, because normative economic analysis of law is concerned with providing law-makers and other social actors with new ideas to the normative challenge of how to improve the law.

I will return to essay-specific research objectives later. Before that, I wish to address some general methodological issues that are relevant to all the essays.

2.2 METHODOLOGY

Given the research objectives of the dissertation (theory development and policy advice), various methodological questions can be raised. I will refrain from sticking my head into the bigger haystack of economic methodology, but will instead focus on four concerns of more immediate relevance: the challenge of normative research, the problem of how to evaluate competing models and theories, the mode of argumentation, and the difficulties and choices with respect to precision.

2.2.1 The Challenge of Normativity

I said earlier that the basic question of the dissertation is normative (*"To regulate or not to regulate, and if to regulate, how?* or *"How can we improve law and regulation?"*). What I mean by that calls for a clarification.

By normative research I mean something quite specific, which is not necessarily the same as what it means in economic analysis of law. Normative Law and Economics, generally speaking, refers to the making of legal policy advice based on the economic analysis of the question, but more specifically, it means policy advice based on the notion of *efficiency*, and in particular, *allocative efficiency* (Kerkmeester, 2000: 386). As is well known, that seemingly simply and intuitive term is full of ambiguity, which is why thousands of pages have been written on different efficiency concepts, principally *Pareto efficiency or Pareto optimality* (a state in which no one can be made better off without making someone else worse off) and *Kaldor-Hicks efficiency* (an outcome in which those that are made better off could in theory pay compensation to those that are made worse off). There are general difficulties such as that Pareto-improving policy changes are practically non-existent, because all (or almost all) policy changes imply some disadvantage to someone somewhere; and that Kaldor-Hicks improvements are not necessarily *in fact* compensated, which implies that sometimes they may be manifestly unjust. Further, there is the all-the-more-fundamental difficulty of how we are to make interpersonal utility-comparisons if such utilities cannot be observed and their interpersonal comparability is in any case doubtful (Kerkmeester, 2000: 387).

One simple solution to the endless debates on efficiency is the *principle of wealth maximization* adopted by Posner in his *magnum opus* (2011: chapter 1). According to this approach, preferences are expressed by *willingness to pay*, so that the normative objective of legal policy is the promotion of wealth maximization. However, the philosophical problems with Posner's solution have been well analyzed by Dworkin (1980) in his famous article "Is Wealth a Value?" as well as by numerous other commentators.

For present purposes, suffice it to say that I do not consider Posner's solution entirely satisfactory. It will be evident from the arguments contained in this

study that I tend to disagree with the standard rationality postulate, which claims that economic agents act merely so as to maximize their utility; I believe that both "maximization" and "utility" are problematic notions in the context of human choosing and acting. Moreover, I decidedly disagree with the principle of *pragmatic economism* according to which people act merely so as to maximize their wealth. It should be no surprise, then, that I do not think that the *normative* objective of legal policy should be wealth maximization as such.

It is neither possible nor desirable for me to explain in detail my legal and political philosophy here, so a brief sketch will be enough to clarify the matter (for a longer exposition of likeminded ideas, see for example Finnis, 1980). The primary goal of law is not efficiency, but *justice*. The notion of justice includes many different dimensions, which classically are categorized as commutative, distributive and general justice (Finnis, 1980: 161-193). From the viewpoint of law and legislation, the principal objective is general justice (also called "legal" justice by Aristotle), which essentially boils down to favoring and fostering the common good of the community (Finnis, 1980: 164). The *common good* is defined not as some kind of collectivized good, but as *the set of conditions that enables the members of a community to lead good and fulfilling human lives both individually and in collaboration and communion with others* (Finnis, 1980: 154-156). What these conditions are in practice is a vast question, but at the most basic level they certainly include such factors as a functioning market, access to justice, transparent political institutions, a healthy natural environment, respect for life and bodily integrity, right to private property, freedom of association, a positive moral ecology, and so on. It is the common good, not mere private interests, which forms the *principal normative objective* of both the general legal institutions and specific regulatory policies, even if these may in fact also advance private interests.

According this understanding of law and justice, *considerations of efficiency form part of the common good and therefore of general justice*; the economic perspective is not outside the realm of justice, but is included within in. This means, on the one hand, that *Pareto optimality is too restrictive* as a universal criterion of law and justice, because it treats all established private interests as trumps, i.e. overriding rights. On the other hand, efficiency is not an absolute value, but is subject to the wider considerations of justice, including certain fundamental rights of individual persons (Finnis, 1980: 111-118); in other words, *Kaldor-Hicks efficiency is too expansive* as a universal criterion of law and justice, because it gives efficiency undue importance to the exclusion of other values.

Now, as far the present dissertation is concerned, it should be emphasized that nothing fundamental hinges on the acceptance of this broad normative framework. The argumentation does reflect this framework, but in general, it is *regulatory-theoretical* in the sense that it leans more on *specific legislative and regulatory objectives* than the Posnerian-type Law and Economics, which tries to offer an all-encompassing descriptive and prescriptive account of all law based

on economic efficiency (see Baldwin and Cave, 1999, for a representative example of "regulation theory" in this sense).

In other words, the essays do not propose legal policy prescriptions based on efficiency considerations or other normative theories, but they analyze regulation on the basis *objectives taken as given*, and determined ultimately by political choice; these objectives may and should be discussed critically, but they are not the principal focus of the present study. This is quite explicit in essays 1 and 2, which work in the context of financial regulation as commonly defined, i.e., taking as given such policy objectives as macroeconomic stability, efficient risk allocation, and consumer protection. The purpose of these essays is not the challenge these widely accepted objectives of financial regulation, but to contribute to the discussion of the most apt policies for achieving those objectives.

The other two essays are slightly more open-ended in terms of their normative basis. Essay 3 does not specify concrete policies other than by way of illustrative examples, so that ultimately the prescriptive content of the proposals requires further concretization. However, there are also references to broader considerations of a good society along the lines of the *common good* as defined earlier. Essay 4 is similar to the previous essay, except for the fact that it also proposes virtues as an objective of legal policy, and provides some normative arguments in support of that objective. Those normative arguments are, again, along the lines of the notion of common good, placing however special importance to considerations of economic efficiency.

2.2.2 Evaluating Models and Theories

The previous section implies that, although the basic research questions of the dissertation are essentially normative, most of the actual analysis focuses on the descriptive theories and analytical frameworks that form the basis of normative conclusions in the context of legal policymaking. It follows that an important methodological challenge is that of evaluating different theories and proposing new frameworks that might be better than the alternatives.

There is a fundamental question, which cannot be entirely avoided: *How are scientific models and theories evaluated?*[2] And more specifically: *How are the models and theories of economic analysis of law evaluated in this dissertation?* The first question, which forms the heart of the philosophy of science, can only be touched upon cursorily here, that is, by way of addressing the second question.

---

[2] I am using the terms *model* and *theory* broadly interchangeably, although I think that theory should refer to more expanded totalities, whereas models form part of theories. In this I concur with Uskali Mäki: "The linguistic practice of economists often does not distinguish between 'theory' and 'model' but for many purposes it is useful to think of models not only are representing the world but also as representing theories, as their reduced or enlarged representatives. Models in this sense 'mediate' between theories and the world or the data." (Mäki, 2005: footnote 1).

In his famous *Methodology of Economics* (1992), Mark Blaug discusses the near-impossibility of finding any single universally accepted philosophy of science today. Whereas a certain type of logical positivism was broadly accepted in the early 20th century and classical physics was seen as "the prototype science to which all other disciplines must sooner or later conform", today things are difference, because "the works of Poppe, Polanyi, Hanson, Toulmin, Kuhn, Lakatos, and Feyerabend [...] have largely destroyed this *received view* without, however, putting any generally accepted alternative conception in its place" (Blaug, 1992: 3).

That is not to say that there is no agreement at all on what sort of criteria should be used to evaluate models and theories. Ultimately, those criteria are commonsensical factors that simply eschew the sophisticated debates of philosophy of science: one asks, if facts are correctly stated; if other facts are omitted; if the generalizations are subject to counter-examples; and if one can find competing models or theories that will fit the facts (see Blaug, 1986: 279). Ideally, this process – which in fact reflects the so-called *hypothetico-deductive model* of scientific knowledge – should be done as rigorously and carefully as possible.

Even if no standard method science is available, it is useful to reflect briefly on the methodological suppositions of the present dissertation in light of different methodological theories. Importantly, it is evident that the study does not follow Milton Friedman's famous "instrumentalist" proposal, according to which theories are assessed solely on the basis of their predictive power (Friedman, 1953). Friedman's approach, and especially its *irrelevance-of-assumptions thesis*, is both ingenious and, frankly, laughable (see Blaug, 1986: 273-278, and Blaug, 1992: 91-99, for a critique). This is especially true of its extreme form, dubbed humorously the *F-twist* by Paul Samuelson. Firstly, while assumptions are – without doubt – necessary for scientific theory, their realism and conformity to the object of study is one factor in the evaluation of the *plausibility* of the theory (Kerkmeester, 2000: 394). Samuelson opts for harsher words:

> "[Friedman] is fundamentally wrong in thinking that unrealism in the sense of factual inaccuracy even to a tolerable degree of approximation is anything but a demerit for a theory or hypothesis." (Samuelson, 1966: 1774; quoted in Blaug, 1992: 97)

Secondly, as behavioral economists have demonstrated, unrealistic assumptions often fail to yield good predictions about the empirical world (Kerkmeester, 2000: 392). Thirdly, as Coase (1994) has pointed out, the methodological importance of predictive power greatly depends on the nature of the research and the *type of knowledge* one is aiming at; in the summarizing words of Kerkmeester (2000: 394):

> "If [the goal of research] is only prediction and control, the use of unrealistic assumptions is fine, as long as they indeed predict well. If, however, the goal is explanation, an approach based on unrealistic assumptions is not really helpful in providing insight in what really moves a person and in how legal rules really have effects."

If the present study avoids the philosophically floppy logical positivism or "instrumentalism" of Friedman and company, it also shuns the *apriorism* of some earlier forms of economics, including British 19th century economics and later Austrian economics (see Blaug, 1992: 51-82). While I do not entirely rule out the possibility and fruitfulness of classical-style "armchair economics", I am convinced that it, too, in fact relies on empirical input, or otherwise it is quite useless. And if so, it is necessary to recognize the role of observation and to be more accurate about the nature of the reasoning process.

The foregoing implies that the methodological position of the present work differs somewhat from the current mainstream in economics, which has been well summarized by Blaug (1992: 110-111):

> "Despite the embarrassment of the *F*-twist, Friedman and Machlup do seem to have persuaded most of their colleagues that direct verification of the postulates or assumptions of economic theory is both unnecessary and misleading; economic theories should be judged in the final analysis by their implications for the phenomena that they are designed to explain. At the same time, economics is held to be only a 'box of tools', and empirical testing can show, not so much whether particular models are true or false, but whether or not they are applicable in a given situation. The prevailing methodological mood is not only highly protective of received economic theory, it is also ultrapermissive within the limits of the 'rules of the game': almost any model will do provided it is rigorously formulated, elegantly constructed, and promising of potential relevance of real-world situations."

Where does that leave the present study, then? I am intent on avoiding any firm commitments, because it seems to me that the lack of any widely accepted methodological theory is a reflection of the fact that most of the theories have some merits but also entail difficulties. Karl Popper's *critical rationalism* and its notion of *falsificationism* is one such view that I take to be broadly correct, at least in terms of most kinds of science (see Popper, 2002 [1935]). I will later comment on some aspects of the dissertation in light of that philosophy.

Another perspective that I find helpful is Thomas Kuhn's notion of *paradigms* (Kuhn, 1970) and Imre Lakatos' related notion of *scientific research programs* (Lakatos, 1977). For present purposes, I refrain from entering into the differences

of those notions, taking them to be broadly similar; I should emphasize that I do not subscribe to Kuhn's epistemological views which are essentially relativistic, nor do I agree that different paradigms are entirely incommensurable. The point, at any event, is that Kuhn's and Lakatos' notions fruitfully highlight the *holistic nature of science:* scientific models and theories are not evaluated in isolation, but as forming part of broader paradigms or research programs, which should be assessed in a holistic manner. Thus, it is neither the realism assumption nor the predictive power alone that determines the strength of a theory, but both of those factors as well as many others.

The Kuhnian or Lakatosian view of science helps to understand better what it is, exactly, that the present dissertation attempts. The purpose of the essays contained here is neither to perform empirical tests in order to check the validity of specific economic models, nor to build arm-chair theoretical models in contempt of empirical observation. Instead, the *principal contribution is to apply realism-based economic models to legal and regulatory policy*. In this, the essays are contributing to the theoretical development of one paradigm or research program within Law and Economics, drawing on empirical work done by others.

Thus, essays 1 and 2 rely on empirical research called *behavioral economics* and apply it to the theory of financial regulation. The choice of behavioral economics as the basis for regulatory policy is made on the grounds that it is *more realistic* than the standard neo-classical model. However, the leading question of the essays is not so much "What does cognitive psychology say about human behavior?", but "What implications does the empirical evidence embodied in behavioral economics have for financial regulation?"

The other two essays are similar in methodology, although they rely on a wider source of ideas in order to advance the development of realism-based economic models. Essay 3 uses, on the one hand, conceptual and empirical studies on the notion of social norms and, on the other hand, empirical evidence on internal and moral motivation; but again, the primary focus is on working out what all of that implies for law and regulation. Essay 4 cites less empirical evidence to support the realism-based theoretical model, as it relies mostly on the classical literature on virtue theory (which, in any case, is broadly based on observation and experience), but it does also receive scientific support from the new literature on *positive psychology* (see Peterson and Seligman, 2004, for an extensive synthesis of the empirical literature). Again, the focus is on what implications this has for legal policy.

In terms of paradigms and research programs, it is interesting to ask how the essays in the present dissertation develop or challenge existing paradigms. In brief, it seems to me that the first three essays are more modest in this sense, in that they propose no radical changes to current thinking, although they do help to undermine the dominance of the standard neo-classical view. Principally, essay 1 is a kind of *internal criticism* of certain opinions held in behavioral financial regulatory theory, whereas essay 2 is an extension and a more detailed

application of earlier literature within the same paradigm. Essay 3 is a redevelopment and systematization of the literature on social norms and law, although it also combines it with other, complementary perspectives. Essay 4 is the most innovative and path-breaking of the dissertation, in that it proposes quite a novel view of economics (and, by implication, of Law and Economics); however, I argue in the essay that the classical virtue theory is in principle compatible with one interpretation of rational choice, and it resonates well with behavioral economics, so there is the possibility that the view advanced here could be absorbed into existing paradigms.

2.2.3 Theory Development: Inductive and Deductive

Another issue that I wish to clarify is this: *How exactly do I work out the legal and regulatory implications of these arguably-more-realistic models of economics?* Traditionally, modes of reasoning have been divided into deductive (working from general premises to particular conclusions) and inductive (working from particular observations to generalized conclusions). That distinction is a simplification, and good science uses both in a creative process, but, still, there is a difference of emphasis, and consequently research can often be classified as emphasizing either induction or deduction. For example, most of economic research follows the deductive model (or deductive-hypothetical, if the deductive results are tested empirically). On the other hand, some authors such as Ronald Coase have tended to follow an inductive approach, looking for interesting observations of social and legal phenomena and using them to formulate conclusions that are, perhaps, not so formally rigorous but that are nevertheless very interesting (see Kerkmeester, 2000: 391-392). Richard Posner has in some writings accused Coase of not developing *any theory at all,* but this seems like an unjust claim that reflects Posner's misguided understanding of the notion of theory (see Mäki, 1998).

The essays in this dissertation combine both deductive and inductive argumentation. The first two essays are principally *inductive*. Essay 1 is a collection of different perspectives and examples that point in the direction of the general argument of the essay (according to which behavioral economics does not imply more but less financial regulation). In fact, the fundamental point of that essay is to challenge the *simplistic deduction* that behavioral economics means that heavier regulation is needed ("less rationality implies *more* regulation"). From a Popperian (*falsificationist*) perspective, the arguments of that essay serve to *refute* at least the extreme form of the counter-hypothesis. Naturally, the evidence should not be seen as completely *verifying* the principal hypothesis of the essay ("less rationality implies *less* regulation").

Essay 2 is closely related to the previous essay. It also draws heavily on different kinds of empirical observations and arguments, so that the style of argumentation is quite inductive. From a Popperian perspective, it might even be seen as *falsifying the extreme form of the hypothesis of essay 1* ("less rationality

implies *less* regulation"): what emerges is a more nuanced view that acknowledges the positive contribution of a certain kind of regulation when economic agents are imperfectly rational.

Essays 3 and 4 are, in contrast, more *deductive*. Essay 3 is principally a *systematization* of a range of recent literature that highlights the social importance of non-legal and informal sources of normativity. In other words, the contribution of that essay is to draw out a range of legal and regulatory implications from those perspectives which, in themselves, are firmly grounded in empirical facts. The essay does discuss many supporting and illustrating examples, which add to the plausibility of the analysis, but the logic of the argument follows a deductive mode. Essay 4 is likewise a largely deductive study of the legal policy implications of the classical virtue theory. The thread of the argument starts from a consideration of the fundamental assumptions of rationality in human action, and proceeds by drawing out the principal implications that changing the assumptions has for a variety of general legal policy options. Again, the supporting examples are more illustrative than verifying, although they do still add to the plausibility of the argument.

2.2.4 Technique and Precision

One remaining methodological issue is that concerning technique and precision. By precision I mean both conceptual and empirical exactitude. The challenge of precision and rigor is a perpetual one in any kind of science, and it has been well summarized by Aristotle in a famous statement in *Nicomachean Ethics* (Aristotle, 1980, I:3):

> "[I]t is the mark of an educated man to look for precision in each class of things just so far as the nature of the subject admits; it is evidently equally foolish to accept probable reasoning from a mathematician and to demand from a rhetorician scientific proofs." (emphasis added)

The reason why this calls for reflection is that there are those in economics, who hold that scientific rigor is *co-extensive with mathematical modeling* (see Kay, 2011b, for evidence and critique). Since the present dissertation avoids mathematics, it seems appropriate to briefly explain, why.

One reason for avoiding mathematical formalism in the present essays is a *pragmatic* one: the intended audience is such that even a single mathematical formula would risk diminishing the readership to a fraction of its potential. Such is the nature of professional prejudice.

There is another reason, too. While I do not deny the potential usefulness, or even strict necessity, of mathematics in certain contexts, I do believe that the scientific benefits of mathematical formalism are (i) rather *overestimated* within the economics profession and any in case (ii) highly *dependent on the nature of the question at hand*. This is not only because in some rare instances the resort to

mathematics may function as camouflage that masks the lack of depth in substance or the fact that the model stands on feet of clay.[3] More fundamentally, it is a question of *choosing the method to fit the question*, and not the other way around. In the insightful words of John Kay (2011b: 7):

> "Economic models are no more, or less, than potentially illuminating abstractions. [...] Economics is not a technique in search of problems but a set of problems in need of solution. Such problems are varied and the solutions will inevitably be eclectic."

Of course, many questions can be treated both mathematically and verbally, but the nature of the treatment will be affected in many ways, not merely in logical rigor. Indeed, the widespread philosophical criticism of what I call "*normative economism*", no matter how formally displayed, reveals that rigor in one (e.g. mathematical) sense does not guarantee it in another (e.g. philosophical) sense.

In the present set of essays, the methodological choices with respect to precision might be called *satisficing*, following Herbert Simon's famous expression (see Simon, 1947). In other words, the analysis is decidedly verbal, and the empirical evidence used is either based on research by others or on casual observations rather than rigorous empirical regressions, because it is "good enough" for present purposes, that is, in light of the research questions and objectives that I have set for the essays. At times, the argument invokes detailed empirical studies made by others; in those cases, it is a question of combining that kind of data with broader theoretical considerations and, thereby, reaching better normative conclusions for legal policy.

The amount of exactitude also varies somewhat between the essays, depending on the scope of each essay. Essay 1 examines a relatively broad hypothesis, so the style of argumentation is sketchier than that of essay 2, which looks at a narrower issue and can therefore go into much greater legal and empirical detail. Of the last two essays, essay 4 covers an especially wide range of theoretical issues, so that the style of argument is more "impressionistic"; this is justified by the fact that the essay is advancing a novel perspective to economic analysis of law, and I have judged it more opportune to present a *holistic* analysis here, leaving more detailed studies for further research.

---

[3] In essay 4, I refer to one paper which I believe is rather worse, not better, in substance due its heavy use of mathematics (Dal Bo and Terviö, 2008). It might be an isolated instance, but I doubt it.

3 Results and Reflection

In what follows, I will briefly reflect on each essay. First, I will outline the principal objectives of the essay and point out what topics and questions have been excluded from the discussion. Second, I will highlight the key contributions of each essay to the existing literature. Third, I will try to discuss some potential weaknesses and limitations of the essay, and sketch possibilities for further research.

3.1 ESSAY 1: BEHAVIORAL ECONOMICS AND FINANCIAL MARKETS

3.1.1 Objectives and Exclusions

The first essay, entitled *"Behavioral Economics and Financial Markets: More Regulation or Less?"*, was largely inspired by the academic and other commentaries made during and after the global financial crisis. While the interpretations of the events differed greatly, it was frequently argued that the crisis had proven the irrationality of investors and that, therefore, heavier regulation of financial markets was the way forward. As I point out in the essay, even generally, scholars within Behavioral Law and Economics (BLE) tend to be rather *pro-regulation*, whereas neoclassical legal-economists are more inclined toward *anti-regulation*.[4] This goes so far that it is arguable that some of the opposition to BLE may be motivated by the *political implications* that it has, or seems to have.[5]

Some authors within the BLE paradigm have expressed mild skepticism of the pro-regulatory tendency of their field.[6] However, to my knowledge, there has been no systematic argument to the effect that BLE could have *anti-regulatory implications*. The principal goal of the paper was to explore the plausibility of such an argument.

The scope of the essay is very wide, given that financial regulation is a highly complex and technical area of law. That means that I had to make significant

[4] For example, see the debate between Bar-Gill (2008), who is fiercely pro-regulation, and Epstein (2006, 2008), who admits that people make mistakes but prefers the neoclassical approaches and argues that competitive markets and the common law are enough to deal with problems.

[5] This tendency can be seen in a wide range of authors cited in the last part of essay 2. See also Epstein (2010), who is quite open about the political issue.

[6] I cite some articles in the essay. It is noteworthy, however, that this kind of arguments are often made by authors who are skeptical of BLE in general.

exclusions in order to make the argument manageable. One was that I do not go into a discussion of the *general validity of behavioral economics*: I simply take it for granted that the BLE paradigm is valid (at least more or less), and I only cite in passing the general methodological criticism that it has received. Actually, in one seminar presentation that I have made on this paper, the question was put to me: "So, do you agree with behavioral economics or not?" The answer would be something like this: "Yes, I do agree with it generally, but I do not consider myself competent to assess all the details and all the models proposed in that paradigm." In other words, I believe that there may be difficulties in some of the arguments made within behavioral economics, but the broader paradigm seems to be supported by strong evidence. In fact, the weakest area of behavioral economics seems to be preference theory, and that has little import for this essay.

Secondly, as I write towards the beginning of the essay, I chose to exclude the notion of *moral psychology or "fairness" behavior*. This was done principally for the pragmatic reason that the regulatory implications of moral psychology seem to be entirely different, and they cannot easily be placed on the scale of "more" or "less" regulation, which was the focus of the essay. Moreover, few commentators have invoked the relevance of fairness behavior in the context of financial regulation. As a matter of fact, I happen to believe that it may be very relevant indeed, but the issues are quite different; essay 3 looks at that sort of questions (although not specifically in the context of financial regulation).

Thirdly, I do not go into discussions of the *normative objectives of financial regulation*. This is done for the pragmatic reason that the existing framework of financial regulation has quite clear policy objectives already, and challenging those would be an entirely different study.

Fourthly, I do not provide a precise definition of what I mean by *"more" regulation*, although I do discuss the issue briefly at the beginning of the essay, and I take it for granted that regulation cannot easily be defined on a more-vs.-less scale. Nevertheless, given the broad scope of the essay, I believe it is a workable short hand expression for the idea that regulation can be more or less restrictive, more or less onerous, more or less interventionist.

3.1.2 Contributions

This essay is, to my knowledge, the first article advancing a systematically *regulation-critical* view based on behavioral economics. What makes it interesting is precisely its *counter-intuitive* nature: it seems somehow "obvious" that less rationality should lead to more regulation.

The thesis of the paper is based on five arguments. Firstly, it is shown that behavioral economics does not automatically imply the need for heavier regulation, because it also reveals the possibility of so-called *light-touch regulations* along novel lines that would not be possible within the neoclassical, rational-choice framework. These include default rules, targeted information disclosure, and cooling-off regulations. This theme is explored in more detail in

essay 2. It is not clear whether the overall effect of the perspective is "more" or "less" regulation, but it clearly points to the possibility of replacing certain intrusive regulations with lighter ones.

Secondly, it is argued that *faulty perceptions about markets* in general seem to be best corrected through market-based solutions. Behavioral economics implies that financial market participants tend to be misled by a range of factors about investment prospects, and some commentators have called for the establishment of regulatory tools to help "debias" faulty market perceptions. Although I do not deny the possibility of such measures, I argue that we should not entertain high expectations about them, because the track record of public authorities in predicting crises is rather poor, and their resources and incentives for doing so are weak in comparison with the private sector. Some private sector actors already provide plenty of high quality "debiasing" activity, and it seems that it would be better to reinforce and harness those activities.

The third argument is that increasing regulation does not seem to solve problems caused by *lack of market discipline, pricing inefficiencies and financial innovation*; in fact better results might be achieved through simpler rules. This argument covers a wide range of issues that go to the heart of financial regulation; my objective is simply to pinpoint some crucial factors in light of behavioral economics. The analysis of financial innovation, instability and regulation seems to me to be particularly novel, and it would merit significant further research.

Fourthly, regulatory rule-makers are subject to imperfect rationality, which tends to reduce the quality of regulatory intervention. This phenomenon is pejoratively called *"behavioral bureaucrats"*. The analysis is a kind of extension of the widely accepted public choice theory, which challenges the assumption of perfect and well-intentioned law-making. My analysis shows that the findings of behavioral economics *reinforce* the tendencies identified by public-choice theorists, which means that in a behavioral framework, one ought to expect even worse-quality regulation (naturally, the quality issue cannot easily be quantified, and one should be careful not to imply that we know exactly how large the effect is). I also show how the behavioral view explains many anomalous phenomena that we seen in financial regulation. I discuss, finally, the possibilities of institutionally mitigating the harmful effects of human psychology in law-making, but the overall prospects seem unpromising.

The fifth and last argument is that *regulatory complexity* seems to exacerbate the harmful effects of limited rationality, while simple rules have *positive learning effects*. This is a complex issue, yet perhaps the most interesting one theoretically. I argue that, in light of behavioral economics, it is actually *good* to have some crises from time to time – but they should be *frequent and small*. In terms of institutional solutions, this seems to imply that the rules should not be excessively protective of investors, and that decentralized regulation has advantages not acknowledged by traditional models.

3.1.3 Limitations and Further Research

Given the counter-intuitive character of the argument, the essay was intentionally *provocative*. That also means that I did not try to address all the possible objections to my argument, wanting to leave them for further debate. However, I wish to reflect here briefly on some of the limitations of the argument. For the most part, these limitations are not in any sense fundamental, but rather are invitations to further research.

One of the principal limitations of the essay is that it claims to make a *generalizable thesis* ("less rationality, less regulation"). I have already discussed this issue in the methodological section: the argument of the essay should not necessarily be seen as trying to *prove* that BLE implies an anti-regulatory stance. Rather, the objective is to *disprove* the counter-hypothesis that BLE implies a pro-regulatory stance. It leaves it open where exactly the line should be drawn. Note that essay 2 of the dissertation provides as slightly different conclusion, which should be seen as complementing essay 1.

A related criticism would be the following. Given that the argument relies on *examples taken from highly technical and complex matters*, one wonders if the examples are chosen and discussed fairly and not in a biased way. Further, given the complexity of those issues, they are probably contentious and therefore their treatment in this essay is subject to dispute. In conclusion, the question is how strong the argument can be if its constituent parts are not absolutely clear.

These are important concerns, and my response would be as follows. Firstly, as far as the examples are concerned, I have tried to choose them in a fair manner, and I do consider some possible counterarguments in the paper. In any event, it is hard to judge one's own impartiality, so that matter should be submitted to further debate. Secondly, it is true that some of the technical issues are contentious and there are different opinions. I have tried to take note of some of the differences, but for pragmatic reasons, it has not been possible to go into all the related literature, given the wide scope of the essay. In any event, I do consider the substantive positions taken in the paper as strong ones, not as odd opinions held by a marginal few. Thirdly and most importantly, the structure of the argument is such that it would not collapse even if some of its parts were to be wrong; that would only weaken or soften the general conclusion. In other words, the inductive mode of reasoning implies that the argument is *not* only as strong as its weakest link, but instead, the different parts of the argument are *converging evidence*, and as such they must be evaluated separately.

A third and related issue concerns the *generality and applicability* of the argument. The examples are taken from financial markets regulation, so one might ask whether the conclusions can be applied to other areas of regulation. On the other hand, is the thesis equally strong for all types of financial

regulation, or is it valid for some only? These are interesting questions, which call for further research. I would be inclined to opt for a *middle position*: the argument probably can be generalized into other fields, too, but one should enquire into further details. As regards different areas of financial regulation, there probably are some differences: essay 2 discusses that in detail.

Fourthly, it might be argued that the *inexactitude of the notion of more-vs.-less regulation* lends itself to imprecise analysis, and as evidence of this we have the fact that, in the examples discussed in the essay, it is not always clear what "less" regulation means. Indeed, I make the point that I am inclined to favor something like "narrow banking" or even "100% reserves" on demand deposits, and I am of the opinion that the existing Basel rules on capital adequacy are too lax (a view that I do not discuss in the essay, although I criticize the Basel rules on other grounds). I have also argued elsewhere that credit default swaps should perhaps be legally defined as insurance contracts, which would significantly limit their use (Juurikkala, 2011). Now, it could be argued that all of this implies that I favor heavy regulation in some cases.

A brief response is as follows. For one thing, many of the reasons for holding those views have little or nothing to do with behavioral economics. Therefore, those views as such do not disprove the argument of the present essay, because that argument is about the *relative* effect of behavioral economics for financial regulation, *not* whether there should be financial regulation or not, all things considered. Whether the behavioral view weakens or reinforces the case for those views mentioned earlier, I have yet to investigate. For another thing, as I argue in the essay, often problems in one area stem from overregulation in other areas, and frequently one (reasonable) type of regulation is a response to problems caused by other (unreasonable) type of regulation. This reflects the classic argument that interference with market dynamics (e.g. by way of price controls) causes "market failures" that have to be "solved" by further interventions (e.g. socialization of the means of production: see Mises, 1998, for a detailed analysis).

There are many other possibilities for further research, too. One important task is to do *empirical studies* on these issues, in order to gain more accurate information and to test the arguments made here. For example, it would be interesting to see empirical studies on the matter of public choice vs. "behavioral bureaucrats", trying to isolate the relative effects of different factors, for example by comparative studies of different institutions.

Another question was mentioned earlier: could the analysis be extended to *fairness behavior and moral psychology*? It is not clear how the analysis would change, but certainly that perspective would add to the realism of the model. In fact, it might imply a critique of the model in this paper; highlighting cognitive imperfections is certainly a step towards greater realism, but assuming at the same time that our cognitively impaired actors are all *incurable egoists* is hardly enough. Public choice analysis is one area which changes quite considerably if

we scrap the assumption of selfishness. Much work remains to be done in this field; essays 3 and 4 of the present dissertation are modest contributions to that effect.

3.2 ESSAY 2: BEHAVIORAL PATERNALISM IN CONSUMER CREDIT REGULATION

Many of the issues raised in connection with essay 1 are applicable to the other essays too. Therefore, in what follows, I will concentrate on differentiating issues.

3.2.1 Objectives and Exclusions

As I mentioned earlier, essay 2, entitled *"Behavioral Paternalism in Consumer Credit Regulation"*, is closely related to the previous one and can in many ways be seen as its continuation. If essay 1 presents arguments that are highly critical of the benefits of regulation and paternalism, essay 2 offers a complementary perspective, showing that a special type of paternalism may be reasonable, at least in the area of consumer finance. As I have pointed out earlier in the methodological section, this essay can be seen as falsifying the extreme interpretation of the previous essay ("less rationality implies less regulation *absolutely*"). What essay 2 tries to do is to go into greater detail on the potential benefits of a certain kind of paternalism, labeled "behavioral paternalism" (as it is inspired by the findings of behavioral economics).

The principal difference with respect to essay 1 is that this paper has a narrower focus, and therefore it has been possible to go into much greater *legal detail*. In the essay, I explore both the *empirical evidence* on the relevance of behavioral economics in the field of consumer credit, and the existing and possible *legal responses* to those concerns in light of behavioral paternalism.

In terms of exclusions, much of what was said in connection with essay 1 is relevant here, too. For example, the analysis only draws on the role of cognitive imperfections, excluding such aspects of behavioral economics as preference models and fairness behavior.

Other exclusions include that essay 2 only discusses consumer credit markets. This is done both for pragmatic reasons and also because it is arguable that the model of behavioral paternalism is especially applicable in consumer credit markets.

In this essay I draw on a range of legal sources from both sides of the Atlantic (United States and European Union). I have chosen not to go into the national laws of European states, although there are some references to Finnish laws when they seem especially relevant and there is no corresponding EU legislation.

3.2.2 Contributions

Firstly, essay 2 presents a theoretical model of *behavioral paternalism*. It reviews a range of literature in Behavioral Law and Economics (BLE) and generalizes it into one model. It also assesses the applicability of that model in different areas. Indeed, one of the important issues discussed is whether the same model would be equally applicable to areas of finance other than consumer credit; it is argued that probably not – at least, not with the same force – because the special conditions surrounding consumer credit are such that the behavioral model seems to be especially relevant. In other areas, for example banking regulation, the behavioral model does have its relevance, but the model of behavioral paternalism is less likely to be fruitful.

The essay then examines the prospects for behaviorally-inspired paternalism by way of three types of regulation: information disclosure, default rules (opting out), and cooling-off periods. Each of these is examined in the context of (a) home loans or mortgages, (b) credit cards and (c) instant loans. It is found that there are substantial prospects for fruitful regulation along these lines, although in some cases (for example, cooling-off periods) it seems that the rules should be defined very carefully, because it is clearly possible that well-meaning regulations end up creating more harm than good.

The benefit of examining more legal details is that this paper does not merely evaluate the *general* implications of BLE; it also advances a *model of legal policy* along the lines of behavioral paternalism. Thus, the essay looks not only at possible regulatory solutions, but also explores existing laws in light of this perspective. It is found that on both sides of the Atlantic, there is a surprising amount of legal rules in consumer finance that reflect this kind of thinking. From the theoretical perspective, therefore, the essay advances both *normative* and *"interpretive" or "explanatory"* behavioral-economic analysis of law (the latter resembles what Richard Posner calls "Positive Law and Economics": see Ogus, 2004: 383-385).

Finally, I present criticism of the model of behavioral paternalism, drawing on earlier literature as well as novel arguments. I argue that some of the earlier critique is misplaced, but some skepticism is entirely justified. I also suggest that we should explore the possibilities of combining private-sector initiatives with light-touch regulation, or develop legal rules that foster the creation of helpful market-based solutions. This is because in most cases, there are potential benefits to all or most market participants from systems that help consumers make better choices, and private sector actors tend to be more innovative than regulators in devising such systems.

In fact, the issue of criticism is one in which this essay makes a significant contribution. The reason is that, as I see it, the earlier literature on behavioral paternalism has been far too *sketchy*: even papers by Cass Sunstein (the most important author within this school of thought) tend to be rather impressionistic in terms of legal details. That has made it rather too easy for the skeptics to

criticize the proposals, because it is not very clear what really is being proposed, and, frankly, many of the examples given by Sunstein and colleagues have been unconvincing. The present paper provides more substance to the idea of behavioral paternalism, and that helps to evaluate more reasonably the debates on the merits of paternalism in legal policy.

3.2.3 Limitations and Further Research

In terms of weaknesses, the principal issue in essay 1 is the same one as in essay 2: the argument relies on some technical issues that are subject to *ongoing debate* among experts. One such issue is the extent to which bounded rationality is the cause of the malfunctioning of consumer credit markets, given that other factors have played a role, too.

In this essay I have attempted to consider those debates in more detail, and I discuss some of the empirical debate in the last part of the paper. As I write there, I agree with some of the skeptics: there is a tendency among some proponents of BLE (for example, Elizabeth Warren) to overstate their empirical case and to rely too much on anecdotal evidence that is subject to a range of interpretations. On the other hand, the skeptics sometimes seem to go to the other extreme, downplaying even the stronger type of evidence. This phenomenon reflects the *politicized* nature of the debate, as each side may be motivated not merely by scientific curiosity but also by the political implications of the arguments.

In any case, it seems to me that these uncertainties are not hugely important for the present essay. Ultimately, the case for behaviorally-paternalistic regulations depends on the empirical evidence, which should be studied carefully before implementing legal reforms. Note, however, that I disagree with Cass Sunstein on a matter of principle: he writes in a famous paper that "objections to paternalism should be empirical and pragmatic, having to do with the possibility of education and the likely failure of government response, rather than a priori in nature" (Sunstein, 1997: 1178); however, it seems to me that the *burden of proof* should be on those who argue for paternalistic legal policy, and if we do not have clear evidence, anti-paternalism is justified.

In terms of further research, one big question is whether the *model of legal policy* advanced in this essay could be applied in other areas of law. It seems to me that it could, but the substantive case calls for a detailed analysis of both the legal and the empirical context. Likewise, the *interpretive or explanatory* model of behavioral paternalism could be fruitfully used in other areas of law.

3.3 ESSAY 3: SOCIAL NORMS, MORALITY, AND THE LAW

3.3.1 Objectives and Exclusions

The third essay, entitled *"Social Norms, Morality, and the Law: Regulatory Strategies"*, is concerned with broadening the analytic framework used in economic analysis of law, and challenging the "legal centrism" that is typical of legal scholarship. More specifically, this essay develops a *social norms and morality-based view* of behavior and legal policy, a theme that is taken further (from a different angle) in essay 4.

This essay is a *systematization* of a range of recent literature that highlights the social importance of non-legal and informal sources of normativity. That literature is already significant, but it is also quite dispersed, and it is not entirely clear what it implies for legal policy. Therefore, my principal objective in the present essay was to attempt a synthesis of some of the literature and to create a more *holistic model of legal policy* along its lines.

In terms of exclusions, one question that I do not discuss extensively in the essay is the *normative issue*. As I wrote earlier, the normative basis of this essay is quite open-ended in that the implementation of its proposals requires further concretization of policy objectives. On the other hand, the argument also relies on commonly accepted social values along the lines of the notion of the common good.

Also in this essay I do not intend to expressly challenge the validity of the perspectives relied upon (social norms, internal and moral motivation). Surprisingly, I have as of yet not even encountered any significant criticism of those perspectives.

3.3.2 Contributions

The key contribution of the essay is the *model of legal policy* drawing on the insights of the literature on social norms and intrinsic motivation. That model is a synthesis that I have divided into three types of *legal or regulatory strategies*.

The first category is called *alignment strategies*. These refer to legal policies that seek to align laws with positive social norms and intrinsic motivations. I further identify a range of possible applications and examples of how law should (a) be aligned with positive social norms, (b) be avoided if it seems to corrode valuable social norms, and (c) support positive intrinsic motivation. I also argue that this framework seems to favor the use of broad standards instead of narrow rules (a classic theme in Law and Economics that is further explored in essay 4). Finally, I argue that the model points to the importance of cultural differences, and it provides an *explanatory* perspective on the workings and effect of law in different cultural environments.

The second category of legal strategies is *culture-building and habit-formation strategies*. These are legal policies that seek to change social norms and moral habits for the better. Specific applications show how law should (a) foster

cooperation by combining fairness with toughness, (b) use creative strategies to promote positive social norms, (c) use creative strategies to cultivate other-regarding behavior, and (d) encourage good moral habits and protect the moral ecology of the society. I also point out some danger and challenges that this kind of legal policy entails; the theme is explored further in essay 4.

Thirdly, there are *enforcement strategies* that rely on social norms and moral constraints to implement legal policy objectives. I argue that this may sometimes by advisable because it may both increase the effectiveness, and lower the costs, of enforcement.

3.3.3 Limitations and Further Research

The perspectives relied on in this essay have received little by way of theoretical critique. Such critique would, however, be helpful for the development of the theory itself, because there are obvious concerns about its practical application. The social norms perspective is, surely, very widely applicable, but it is also somewhat vague and it would be important to have more empirical research on it in a range of contexts.

Another limitation of the present essay is that it is quite generic, and therefore it does not go into great detail on legal particulars. One possibility for further research is to look at the examples in more detail, and gather more empirical evidence as well as legal data on existing policies that may reflect this kind of thinking.

A related limitation is that the examples given in the essay are quite anecdotal, so that they may be insufficient for verifying the validity of the model. From a falsificationist perspective, they do have their role in giving plausibility to the model given here, which *indirectly challenges* the traditional, more simplistic (and less realistic) models of legal policy by showing the practical workability and applicability of a more realistic model. However, it would be interesting to formulate *empirically testable* theses and to evaluate them in detail.

3.4 ESSAY 4: LAW AND VIRTUE

3.4.1 Objectives and Exclusions

The last essay, entitled *"Law and Virtue: An Economic Analysis"*, is a highly original study that attempts to bring further realism to economic models and economic analysis of law by incorporating the insights of classical virtue theory into the behavioral assumptions. This is arguably the most innovative essay of the dissertation, as it proposes an entirely new model of economic analysis of law. To be sure, the basic elements of the model are not original, as they simply combine classical virtue theory with modern economics. However, as I show in the literature review of the essay (discussing earlier economic models), there

have been practically no previous attempts to make a holistic model along these lines.

In terms of exclusions, I do not discuss in detail the potential criticism of the classical virtue theory, although I do mention some recent critique as well as responses given to it. As I explain in the essay, that critique seems largely unfounded, but in any case it would be an entirely different study to discuss the matter in depth.

3.4.2 Contributions

Essay 4 is the most innovative and path-breaking of the dissertation, as it proposes a novel view of economics and, by implication, of economic analysis of law. However, I argue in the essay that the classical virtue theory is in principle compatible with one interpretation of rational choice, and it resonates well with behavioral economics, so there is a possibility that this view could be absorbed into existing paradigms.

The key contributions can be divided into two: those pertaining to economics proper and those pertaining to legal theory. Within *economic theory* in the stricter sense, the essay includes a literature review of virtues in economics, and finds that quite little of substance has been written earlier from this perspective. It also makes a comparison of the virtue-based behavioral assumptions with other models in economics, particularly the standard rational-choice model, the behavioral economics model and the notion of human capital. The comparison reveals interesting similarities and differences between the models, suggesting that the virtue perspective sheds new light to existing frameworks. Finally, an analysis of the economic benefits of virtues is conducted, structured according to the classical notion of the cardinal virtues.

In terms of *economic analysis of law*, the essay outlines a virtue-based economic analysis of law along two levels, labeled static and dynamic analysis. In the *static analysis*, it is assumed that a fixed "level of virtue" exists, and optimal legal policy is studied across different dimensions of legal design. The analysis suggests that a high level of virtues should go together with (i) more freedom (fewer legal constraints), (ii) morally more demanding laws, (iii) more precise legal norms, (iv) broader standards as opposed to narrower rules, (v) lighter sanctions, and (vi) wider popular participation in law-making. The results are the opposite if the level of virtue is low (i.e. level of vice is high). It is also examined how law-makers might deal with such problems as lack of information and heterogeneous agents.

In the *dynamic analysis*, the focus is on optimal legal policy in order to promote a higher level of virtues. A paradox is found: on the one hand, law seems to be necessary for the practice and promotion of virtuous behavior; on the other hand, law may also be counterproductive in this respect. This suggests that law-makers wishing to promote virtues should take special care to identify the relevant factors and potential consequences of their actions. The analysis

also warns against *legal perfectionism:* it is important to acknowledge the limits of law and to understand the subsidiary role that law plays in promoting a virtuous society.

3.4.3 Limitations and Further Research

As I wrote earlier, this essay is an outline of novel ideas, and naturally much work remains to be done. The model present in the essay is a kind of *experiment* (i.e. a thought experiment) in the sense explained by Mäki (2005: 308), as it uses the *method of isolation* to work out the effect of introducing the notion of virtues into economic analysis.

Several possibilities for further research can be identified. On the *theoretical* level, there is scope for further comparative investigation of the assumptions of neoclassical, behavioral and virtue-based economics. I write in the essay that it is probably possible to make a mathematical model along the lines of virtue theory, but, so far, it seems that no such model has been made successfully. Also, the deductive model applying the virtue perspective into legal questions could be extended and made more detailed.

On the *empirical* level, further work could be done from a range of directions. One of the big questions is how the presence of virtues could be measured (I propose some possibilities in the essay). Another issue is to formulate empirically testable propositions that could be evaluated using sufficiently large measurement units and long time-spans.

References

Aristotle (1980), *The Nicomachean Ethics*, translated by D. Ross, revised by J. L. Ackrill and J. O. Urmson, Oxford: Oxford University Press.

Baldwin, Richard and Martin Cave (1999), *Understanding Regulation: Theory, Strategy, and Practice*, Oxford: Oxford University Press.

Balzli, Beat and Michaela Schiessl (2009), The Man Nobody Wanted to Hear: Global Banking Economist Warned of Coming Crisis, *SpiegelOnline*, 07/08/2009.

Bar-Gill, Oren (2008), The Behavioral Economics of Consumer Contracts, *Minnesota Law Review*, 92, 749-802.

Blaug, Mark (1986), Economic Methodology in One Easy Lesson, reprinted in *Economic History and the History of Economics*, Brighton: Wheatsheaf Books, pp. 265-279.

Blaug, Mark (1992), *The Methodology of Economics: Or How Economists Explain*, 2nd edition, Cambridge: Cambridge University Press.

Coase, Ronald H. (1994), *Essays on Economics and Economists*, Chicago: University of Chicago Press.

Dal Bó, Ernesto and Marko Terviö (2008), Self-Esteem, Moral Capital, and Wrongdoing, NBER Working Paper No. 14508.

Dworkin, Ronald M. (1980), Is Wealth a Value?, *Journal of Legal Studies*, 9, 191-226.

Epstein, Richard A. (2006), Behavioral Economics: Human Errors and Market Corrections, *University of Chicago Law Review*, 73, 111-132.

Epstein, Richard A. (2008), The Neoclassical Economics of Consumer Contracts, *Minnesota Law Review*, 92, 803-835.

Epstein, Richard A. (2010), Richard Epstein on The Dangerous Allure of Behavioral Economics: The Relationship between Physical and Financial Products, Truth on the Market blog, December 6, http://truthonthemarket.com/2010/12/06/richard-epstein-on-the-dangerous-allure-of-behavioral-economics-the-relationship-between-physical-and-financial-products/ (13.3.2012).

Finnis, John (1980), *Natural Law and Natural Rights*, Oxford: Clarendon Press.

Friedman, Milton (1953), The Methodology of Positive Economics, in *Essays in Positive Economics*, Chicago: University of Chicago Press.

Frigg, Roman and Stephan Hartmann (2009), Models in Science, *Stanford Encyclopedia of Philosophy (Summer 2009 Edition)*, Edward N. Zalta (ed.), http://plato.stanford.edu/archives/sum2009/entries/models-science/.

Hutchinson, Martin and Kevin Dowd (2010), *Alchemists of Loss: How Modern Finance and Government Intervention Crashed the Financial System*, Chichester: Wiley.

Juurikkala, Oskari (2011), Credit Default Swaps and Insurance: Against the Potts Opinion, *Journal of International Banking Law and Regulation*, 26(3), 128-135.

Kay, John (2004), *Culture and Prosperity – The Truth About Markets: Why Some Nations Are Rich but Most Remain Poor*, New York: HarperBusiness.

Kay, John (2011a), Why economists still stubbornly stick to their guns, *Financial Times*, April 16, p. 7.

Kay, John (2011b), The Map is Not the Territory: An Essay on the State of Economics, Institute of New Economic Thinking, September 26.

Kerkmeester, Heico (2000), Methodology: General, in Boudewijn Bouckaert and Gerrit De Geest (eds), *Encyclopedia of Law and Economics, Volume I: The History and Methodology of Law and Economics*, Cheltenham: Edward Elgar, pp. 383-401

Kuhn, Thomas S. (1970), *The Structure of Scientific Revolutions*, 2nd edition, Chicago: University of Chicago Press.

Lakatos, Irme (1977), *The Methodology of Scientific Research Programmes: Philosophical Papers Volume 1*, Cambridge University Press, Cambridge.

MacIntyre, Alasdair (1987), *Whose Justice? Which Rationality?*, Notre Dame, IN: University of Notre Dame Press.

Mises, Ludwig von (1998), *Interventionism: An Economic Analysis*, edited by Bettina Bien Greaves, New York: Foundation for Economic Education.

Mäki, Uskali (1998), Against Posner against Coase against theory, *Cambridge Journal of Economics*, 22, 587-595.

Mäki, Uskali (2005), Models are experiments, experiments are models, *Journal of Economic Methodology*, 12(2), 303-315.

Määttä, Kalle (1997), *Environmental Taxes: From an Economic Idea to a Legal Institution*, Helsinki: Finnish Lawyers' Publishing.

Ogus, Anthony (2004), What Legal Scholars Can Learn from Law and Economics, *Chicago-Kent Law Review*, 79, 383-401.

Peterson, Christopher and Martin E. P. Seligman (2004), *Character Strengths and Virtues*, Oxford: Oxford University Press.

Posner, Richard A. (2011), *Economic Analysis of Law*, 8th edition, New York: Aspen Publishers.

Popper, Karl R. (2002), *The Logic of Scientific Discovery*, London and New York: Routledge.

Rabin, Matthew (1998), Psychology and Economics, *Journal of Economic Literature* 36, 11-46.

Samuelson, Paul A. (1966), *The Collected Scientific Papers of Paul A. Samuelson*, edited by Joseph E. Stiglitz, Cambridge MA: MIT Press.

Sen, Amartya K. (1977), Rational Fools: A Critique of the Behavioral Foundations of Economic Theory, *Philosophy & Public Affairs*, 6(4), 317-344.

Sen, Amartya (2008), Rational Behaviour, in Steven N. Durlauf and Lawrence E. Blume (eds), *New Palgrave Dictionary of Economics*, 2nd edition, Palgrave Macmillan, online version (accessed 16 June 2011).

Simon, Herbert A. (1947), *Administrative Behavior: A Study of Decision-Making Processes in Administrative Organizations*, New York: MacMillan.

Sunstein, Cass R. (1997), Behavioral Analysis of Law, *University of Chicago Law Review*, 64, 1175.

Turner Review (2009), *The Turner Review: A regulatory response to the global banking crisis*, Financial Services Authority, London.

White, William R. (2006), Is price stability enough?, BIS Working Paper No. 205, Bank for International Settlements.

White, William R. (2008), Globalization and the Determinants of Domestic Inflation, BIS Working Paper No. 250.

White, William (2009), Modern Macroeconomics Is on the Wrong Track, *Finance & Development*, December 2009, 15-18.

Essays

BEHAVIORAL ECONOMICS AND FINANCIAL MARKETS: MORE REGULATION OR LESS?

An earlier version of this paper was presented at the Annual Meeting of the Canadian Law and Economics Association, University of Toronto, 1–2 October 2010.

BEHAVIORAL PATERNALISM IN CONSUMER CREDIT REGULATION

An earlier version of this paper was presented at the International Graduate Legal Research Conference, King's College London, 15–16 April 2010.

SOCIAL NORMS, MORALITY, AND THE LAW: REGULATORY STRATEGIES

An earlier version of this paper was presented at the International Conference on Legislative Studies, Helsinki, 1–2 March 2010, and published as "Law, Social Norms and Better Regulation" in Jyrki Tala & Auri Pakarinen (eds.), Better Regulation – A Critical Assessment, National Research Institute of Legal Policy, Research Communications 105, Helsinki, pp. 3–26.

LAW AND VIRTUE: AN ECONOMIC ANALYSIS

Unpublished manuscript.

Essay 2

Behavioral Paternalism in Consumer Credit Regulation[*]

ABSTRACT

Behavioral paternalism is a form of legal paternalism based on the findings of behavioral economics. This paper examines behavioral paternalism in the context of consumer credit, looking especially at the markets for home loans (mortgages), credit cards and instant credit. It finds, on the one hand, that certain aspects of existing consumer credit regulation in the US and the EU are best understood through the lens of behavioral paternalism, and that there are many possibilities for further regulation along these lines. On the other hand, the paper highlights the potential weaknesses of behavioral paternalism, including the fact that even light forms of paternalism may be costlier in practice than they seem on paper. It is also argued that the case for paternalistic policies should be empirically verified, not merely assumed, and that it is important to examine the potential for market-based solutions for helping consumers choose better.

---

[*] An earlier version of this paper was presented at the International Graduate Legal Research Conference, King's College London, 15–16 April 2010.

CONTENTS

1 INTRODUCTION 3
2 MODELS OF BEHAVIORAL PATERNALISM 4
2.1 General Considerations 4
2.2 Paternalism Inspired by Behavioral Economics 5
2.2.1 Libertarian Paternalism 5
2.2.2 Asymmetric Paternalism 6
2.2.3 Debiasing through Law 7
2.2.4 General Assessment and Applicability 8
3 PATERNALISM IN CONSUMER CREDIT REGULATION 9
3.1 Rationale for Intervention 9
3.1.1 Home Loans 9
3.1.2 Credit Cards 11
3.1.3 Instant Loans 12
3.2 Standard Responses 13
4 BEHAVIORAL INFORMATION DISCLOSURE 14
4.1 Home Loans 14
4.1.1 Annual Percentage Rate 15
4.1.2 Standardized Information Sheets 15
4.1.3 Reliance and Conflicts of Interest 17
4.1.4 Broad Ex-post Disclosure Standards 18
4.1.5 Countering Optimism Bias 19
4.2 Behavioral Disclosure for Credit Cards 20
4.3 Instant Loans 21
5 OPTING OUT: DEFAULT RULES 22
5.1 Default Home Loan Design 22
5.2 Default Credit Card Rules 26
5.3 Default Rules for Instant Loans 27
6 COOLING OFF 27
6.1 Home Loans 28
6.2 Credit Cards 29
6.3 Instant Loans 30
7 CRITICISM AND IMPROVEMENTS 31
7.1 General Criticism of Paternalism 32
7.2 Overstating Benefits, Understating Costs 33
7.3 Finding the Right Balance and Combination 35
7.4 Beyond Government 36
8 CONCLUSION 37
REFERENCES 38

1 INTRODUCTION

Paternalism is here understood broadly as the view that people make bad choices more or less frequently, and therefore it is legitimate for the state, or someone else, to intervene—even at a cost to the freedom and autonomy of individuals.[1] Naturally, paternalism is controversial. Many philosophical traditions place an absolute value on human autonomy (e.g. Kantianism), or hold that one should not limit liberty unless some harm is caused to others (J.S. Mill).[2]

In economics, paternalism is unpopular. It is fundamentally inconsistent with the neoclassical model of economic behavior: standard, axiomatic assumptions about rational utility maximization and the identity between preference and welfare imply that people never make mistakes, in the proper sense of the word.[3] Bad outcomes are explained by external factors such as imperfect information, lack of competition, or weak bargaining power: interventions may be justified to correct these problems, but not to protect individuals from themselves.

The *a-priori-anti-paternalism* of mainstream economics has been challenged by so-called *behavioral economics*, which combines economics and psychology (mostly cognitive psychology) to paint a more realistic picture of real human choosing. The goal of the present paper is to critically examine the prospects of what I have termed *behavioral paternalism*. Firstly, I discuss the meaning of paternalism on a general level and outline different paternalistic proposals inspired by behavioral economics. Secondly, I analyze the practical prospects for behavioral paternalism in the context of consumer credit regulation. Finally, I

---

[1] On the concept of paternalism generally, see Dworkin (2010).

[2] The obvious problem with Mill's *harm principle* is that, as the saying goes, "no one is an island" and even private acts tend to create some externalities, sometimes very significant ones. Suber (1999) gives a long list of supposedly "harmless" acts, most of which are actually capable of creating a range of negative externalities, some of them more serious than others: "riding a motorcycle without a helmet, gambling, homosexual sodomy, prostitution, polygamy, making and selling pornography, selling and using marijuana, practicing certain professions without a license (law, medicine, education, massage, hair-styling), purchasing blood or organs, suicide, assisting suicide, swimming at a beach without a lifeguard, refusing to participate in a mandatory insurance or pension plan, mistreating a cadaver, loaning money at usurious interest rates, paying a worker less than the minimum wage, selling a prescription drug without a prescription, aggressive pan-handling, nudity at public beaches, truancy, flag burning, duelling, ticket scalping, blackmail, blasphemy, and dwarf-tossing." The extent and relevance of the externalities is a disputed issue, but it is implausible to claim that they do not exist.

[3] One example of standard economics taken to its extreme is the theory of *rational addiction*, which states that "addictions, even strong ones, are usually rational in the sense of involving forward-looking maximization with stable preferences" (Becker and Murphy, 1988: 657). The theory of rational addiction is a plausible explanation of such "addictions" as love of opera, football or hiking, although it is doubtful whether they can be classified as addictions in the medical sense of the term. The key feature of addiction properly speaking is *time-inconsistency*, which renders it less than rational. See also Becker (1992) and, for a critique, Skog (2005).

advance both general and specific criticisms of paternalism, and try to make a synthesis.

2 MODELS OF BEHAVIORAL PATERNALISM

Before going into practical proposals, let us look at some general conceptual issues as well as the different proposals for paternalism advanced in behavioral economics.

2.1 General Considerations

The economic, and indeed philosophic, acceptability of paternalism depends crucially on both (1) the *claims made* about the way in which people choose (and hence may need assistance in choosing), and (2) the *proposals advanced* for helping people choose better.

In terms of behavioral claims, it is not enough simply to assert that people make mistakes. Several questions should be asked: Do *all people* make mistakes, or only some? Do they make mistakes under *all circumstances*, or only in special settings? *How significant in practice* are those mistakes, and do they merit any concern? Finally, what *costs* are created by intervening?

The last question is intimately connected with the second set of issues, namely the proposed interventions. In common parlance, paternalism is not always understood as helping people make better choices; it implies removing their freedom to choose entirely. It is therefore useful to make some general distinctions (see Dworkin, 2010). One is between *hard and soft paternalism* (coercive intervention, versus merely making sure the person knows what he is doing).[4] Another distinction is between *weak and strong paternalism* (interfering with the means chosen by agents to achieve their chosen ends, versus preventing them from achieving their ends).[5]

Paternalistic policy proposals do not necessarily fall neatly into these distinctions. It may be consistently argued that intervention should in most cases be "soft" (e.g. supplying information), but in some cases, for example suicide, "hard" paternalism (e.g. physical coercion) should be adopted. Similarly, advocates of paternalism may generally favor "weak" forms of paternalism (focusing on facts, not values), but in special cases they may see it as legitimate to hold that someone pursues irrational objectives.

---

[4] "Soft paternalism is the view that the only conditions under which state paternalism is justified is when it is necessary to determine whether the person being interfered with is acting voluntarily and knowledgeably." (Dworkin, 2010)

[5] "Another way of putting [weak paternalism]: we may interfere with mistakes about the facts but not mistakes about values. So if a person tries to jump out of a window believing he will float gently to the ground we may restrain him. If he jumps because he believes that it is important to be spontaneous we may not." (Dworkin, 2010)

2.2 Paternalism Inspired by Behavioral Economics

Paternalistic proposals made by behavioral economists can be generally characterized as being a type of *weak and soft paternalism*: (1) they focus on means, not ends, and (2) they seek to help people choose better by influencing cognitive perceptions, not by using force. This approach follows naturally from the principal message of behavioral economics: people commit cognitive mistakes which prevent them from making optimal choices.

In behavioral economics, the human tendency to make suboptimal choices is often referred to as *biases* (see Rabin, 1998). For example, *salience bias* means that people tend to give too much importance to vivid evidence and emotionally strong experiences, while giving too little importance to logical arguments or dry statistics. *Optimism bias* is the tendency to overestimate the chances of personal success, while underestimating risks to oneself. *Overconfidence bias* means that people overestimate their ability to judge facts and situations correctly. *Confirmation bias* says that people often prefer information that supports their past decisions. *Status quo bias* denotes the tendency to want to avoid changing anything.

Proposals for what I have termed "behavioral paternalism" have been made under a variety of headings. There is a common theme in all of them, but they also highlight different aspects and dimensions of the issue, which is why it is worthwhile to look at them in some detail.

2.2.1 Libertarian Paternalism

Probably the most influential proposal is the so-called *libertarian paternalism* advanced by Sunstein and Thaler (2003), which states that we should "steer people's choices in welfare-promoting directions *without eliminating freedom of choice*" (p. 1159, emphasis added). The way to do that is to influence (or, manipulate) the decision-making context—or *choice architecture*[6]—so that people will end up choosing differently but they will continue to have full freedom to choose otherwise.

For example, the state (or some other paternalistic actor) may regulate the way in which relevant information or the different options to choose from are presented; given that the information-processing capacity of ordinary people is limited, presentation has an impact on actual choices. Or, there may be a default rule which will be followed unless the individual decides to opt out; given that people tend to hesitate and are often uncertain about their choices, the default rule will often be followed. In both instances, actual choices are influenced, perhaps even significantly, but the ultimate freedom of choice is retained.

The justification for libertarian paternalism is therefore two-fold. Firstly, it is argued that people's preferences are unclear and ill-formed, and whether you

[6] See Thaler and Sunstein (2009: chapter 5).

like it or not, their choices will be influenced by default rules, framing effects, and starting points. Secondly, the interventions proposed by libertarian paternalists are so light that they do not in any significant way violate people's autonomy.

The idea of libertarian paternalism is well summarized in a popular book that draws on their extensive academic work, in which the same authors propose the concept of *nudging* (Thaler and Sunstein, 2009: 6):

> "A nudge [...] is any aspect of the choice architecture that alters people's behavior in a predictable way without forbidding any options or significantly changing their economic incentives. To count as a mere nudge, the intervention must be easy and cheap to avoid. Nudges are not mandates. Putting the fruit at eye level counts as a nudge. Banning junk food does not."

2.2.2 Asymmetric Paternalism

Another proposal is that of *asymmetric paternalism*, proposed by Camerer, Issacharoff, Loewenstein, O'Donoghue and Rabin (2003). This is closely related to the previous one in practice, but the theory is slightly different. Asymmetric paternalism builds on the idea that, in all likelihood, some people are better decision-makers than others. In terms of welfare economics, good decision-makers (people who know what they want and how they can get it) should be given more freedom, while bad decision-makers (boundedly rational "idiots") should be treated more paternalistically:

> "a policy is asymmetrically paternalistic if it creates large benefits for those people who are *boundedly rational* while imposing little or no harm on those who are *fully rational*. Such policies are appealing because, even possessing little information about the frequency of consumer errors [...] we can conclude with some confidence that the policy is on net beneficial. Taken to its extreme, pure asymmetric paternalism [which causes no harm to the fully rational types] can only help consumers." (Camerer et al., 2003: 1219, emphases changed)

The authors are more modest than Sunstein and Thaler about the welfare-increasing impact of their proposal. They note, firstly, that even if the freedom to choose is not taken away completely, the implementation of asymmetrically paternalistic policies will involve some costs. Secondly, policies which presumably help consumers correct their errors will imply a net loss to firms, which otherwise would benefit from those errors; of course, this is a rather suspect reason for rejecting asymmetric paternalism.

Given that paternalism always involves some costs, the advocates of asymmetric paternalism propose four types of policies "in increasing order of departure from pure asymmetric paternalism—i.e., the increasing 'heavy-

handedness' of the policy" (Camerer et al., 2003: 1224). These are (1) default rules, (2) the provision or re-framing of information, (3) cooling-off periods, and (4) limiting consumer choices.[7] The appropriateness of these policies crucially depends on the type of bounded rationality that we are trying to correct. The last type of policy is, of course, similar to more traditional product regulation, and usually is not asymmetrically paternalistic at all (the only example given by the authors is the imposition of artificial deadlines to combat procrastination bias). The other three will be discussed later in more detail.

2.2.3 Debiasing through Law

A third variation on the theme is the approach called *debiasing through law*. In their seminal article, Jolls and Sunstein (2006) analyze three types of judgment errors—optimism bias, hindsight bias, and self-serving bias in negotiations – as well as departures from expected utility theory—loss aversion, endowment effect, and framing effects. The crux of this approach is that, instead of using law to influence decision-making generally, law should be used in a more targeted way to mitigate the distortive effect of specific biases: "legal policy may respond best to problems of bounded rationality not by insulating legal outcomes from its effects, but instead by operating directly on the boundedly rational behavior and attempting to help people either to reduce or to eliminate it" (p. 200). The hope is that this, too, would help people make better choices without imposing significant costs or restrictions on them.

Take, for example, consumer safety law (Jolls and Sunstein, 2006: 207–213). The traditional economic way of understanding the problem of consumer choice is that consumers often lack information; the solution is to provide more of it. The problem is that, if people are generally too optimistic about product safety (underestimating the risks that something happens to them personally), accurate information alone will not be enough to yield optimal choices. Typical responses to this concern are either to impose a higher liability standard, or to ban some products altogether; but these involve large economic costs. As an alternative to all these, Jolls and Sunstein propose "debiasing" strategies, which would

> "provide a sort of middle ground between inaction or the earlier prescription […] of providing more information, on the one hand, and the aggressive 'insulating' strategies of heightened products liability standards or outright bans, on the other. Strategies for debiasing through consumer safety law may be far more successful than the mere provision of statistical facts about average risks, and simultaneously far more protective of consumer prerogatives than the strategy of an across-the-board ban." (p. 208)

[7] It is, however, unclear whether default rules are less "heavy-handed" than behavioral information regulation: it really depends on the details of the case.

The principal method proposed by Jolls and Sunstein for debiasing against optimism bias is the *availability heuristic*. Psychology tells us that people tend to neglect dry, statistical information, whereas concrete, narrative information has a stronger impact. Therefore, the law could be used strategically to expose consumers to concrete instances of the occurrence of the risk: for example, the health risk of tobacco is better communicated through personal stories than impersonal warnings.

2.2.4 General Assessment and Applicability

I will offer specific criticism of behavioral paternalism in the last section of the paper, but now it is appropriate to clarify certain theoretical issues. One concerns the theoretical characterization of the approach, while the other has to do with applicability in different environments.

In terms of paternalism theory, behaviorally-inspired paternalism is often "soft" and "weak," but not necessarily. Firstly, many of the proposals embody coercive elements. For example, disclosure rules force lenders to act in a certain way, and cooling-off periods limit people's choices. Indeed, it may be asked whether, in practice, it is possible for the state to intervene *at all* without some form of compulsion. On the other hand, the idea is that the intervention should be as light as possible.

Secondly, the focus is broadly on the outcome of choice, not on the intricacies of how the actor perceives the choice. For example, it is not enquired whether someone might take a highly risky mortgage arrangement simply because he "enjoys the gamble" (a question of ends, not means). Making a strong separation of facts and values in human choice is not feasible in practice, but given that behavioral interventions do not dictate specific outcomes, they leave more freedom for those who have unusual objectives.

One of the principal concerns with the behavioral approach is its applicability in different contexts.[8] There is some evidence which suggests that professionals do not fall into certain behavioral anomalies that are common in the population at large (List, 2003; Gneezy and List 2006). However, it remains uncertain how generalizable these results are: more empirical work is needed. What seems to be clear, in any case, is that the behavioral approach is especially relevant in those contexts in which there is a lot of complex information and people do not gain sufficient practical experience to learn to avoid their biases.[9]

This means that behavioral paternalism is likely to be relevant in such contexts as consumer finance, because the financial issues related to mortgages, for example, are highly complex, consumers have relatively little knowledge and experience, and they may not gain much experience mortgage economics

---

[8] For a study of context-dependence generally, see Kelman, Rottenstreich and Tversky (1996).

[9] Note that the path-breaking work in behavioral economics by Herbert Simon (1947) focused precisely on complex decision-making contexts.

even during their whole lifetime. In contrast, commercial mortgage borrowers probably are much more financially literate and skilful in choosing their lender and negotiating the deal.[10] On the other hand, there are also many consumers who are quite knowledgeable and experienced. Therefore, the notion of "libertarian" or "asymmetric" paternalism is important: if possible, a regulatory intervention should abstain from significantly reducing their freedom to choose.

3 PATERNALISM IN CONSUMER CREDIT REGULATION

This and the following three sections of the paper discuss light forms of paternalistic regulation in the context of consumer credit. The focus is on home loans (mortgages) and credit cards, but there is also a short discussion of so-called instant loans. I will refrain from advancing any major criticism, which is instead reserved for the last part.

3.1 Rationale for Intervention

The effects of limited rationality are especially important in the context of consumer credit (Elliehausen, 2010). Strong evidence is hard to obtain, but an important study by Campbell (2006) concludes that, although many households do make sound financial decision, a significant minority—especially those who are poorer and less educated—makes large mistakes that have serious financial consequences. Furthermore, it has been argued that home mortgages and credit cards are products the markets for which seem to suffer from significant imperfections, which in part are caused by the bounded rationality of consumers but which also exacerbate the negative effects of limited rationality (Bar-Gill and Warren, 2008: 33-43). Therefore, if it were possible to give consumers a helping hand without unduly restricting their freedom to choose, that would seem to be something worth pursuing.

3.1.1 Home Loans

There are many reasons why a helping hand might be welcomed by many credit shoppers. With mortgages:

- the stakes are huge for ordinary people;
- on the customer side there is little repetition and thus little opportunity for learning, and the feedback mechanism is so slow and complex that consumers may never understand what mistakes they made (Bar-Gill and Warren, 2008: 11-14);
- many people understand little about mortgages even on a theoretical level;

---

[10] This fact lends support to the decision of the European Commission to restrict the newly proposed mortgage directive (discussed later) to consumer customers only.

- the choices are very complex and difficult even for finance professionals equipped with sophisticated software (see Shu, 2007);
- the incentives of banks and mortgage brokers often conflict with those of their customers, and unsophisticated shoppers are especially vulnerable to unhelpful advice (note that banks and brokers for wealthier clients have stronger incentives to establish a good reputation, and sophisticated buyers are better able to evaluate the quality of the advice they receive: see Bar-Gill and Warren, 2008: 17-20; Thaler and Sunstein, 2009: 142).

These concerns have been known for a long time, but the topic has become of increasing importance and interest after the recent global financial crisis, which arguably had much to do with problems in mortgage markets in several countries.[11] One interpretation is that the development of increasingly complex loan agreements made it difficult for borrowers to understand what they were doing, making loans appear cheaper and less risky than they really were:

> "Brokers and lenders offered loans that looked much less expensive than they really were, because of low initial monthly payments and hidden, costly features. Families commonly make mistakes in taking out home mortgages because they are misled by broker sales tactics, misunderstand the complicated terms and financial tradeoffs in mortgage, wrongly forecast their own behavior and misperceive their risks of borrowing. How many homeowners really understand how the teaser rate, introductory rate and reset rate relate to the London interbank offered rate plus some specified margin, or can judge whether the prepayment penalty will offset the gains from the teaser rate?" (Barr et al., 2008: 8)

This is not to say that none of these innovations were sensible. However, much depends on the ability of mortgage shoppers to understand what they are being offered, and to assess the appropriateness of the various products to their personal situation. This is why "libertarian" or "asymmetric" forms of paternalism might be the ideal solution: they would preserve the freedom to choose when people know what they need, while helping less sophisticated buyers to avoid deceptive products.

Even excluding spurious mortgage innovations, studies in Europe indicate that consumers tend to have difficulties making optimal choices when taking a mortgage. For one thing, many people have borrowed too much: in 2008, 16% of European citizens reported difficulties in paying their mortgage bills, and 10%

---

[11] On the global financial crisis and mortgages, see Gorton (2010) and Turner Review (2009). However, it is disputed to what extent the problems were fundamentally *caused* by mortgage markets: it can be argued that the misbehavior of housing markets was only one of the symptoms – albeit an important one – of too expansionary monetary policies as well as unsound inventions in structured finance. See Dowd and Hutchinson (2010) and Taylor (2009).

reported arrears (European Commission, 2011a: 4). More recent figures are likely to be worse, as the general financial situation has been deteriorating. Further, it has been found that

> "almost 38 % of EU citizens find it very or fairly difficult to compare offers. [...] Consumers also view the information provided as complex and unclear; 59 % of EU citizens find it difficult to understand information on the way their mortgages work and the risks involved." (European Commission, 2011a: 4)

3.1.2 Credit Cards

With credit cards, similar concerns abound. Both the use of credit card and the average level of debt have exploded in recent years. Consider the following summary from the US, made by Thaler and Sunstein (2009: 148):

- "The U.S. Census Bureau reported that there were more than 1.4 billion credit cards in 2004 for 164 million cardholders – an average of 8.5 cards per cardholder.
- "Currently, 115 million Americans carry a month-to-month credit card debt.
- "In 1989 the average American family owed its credit card companies $2,697; by 2007 that number had grown to about $8,000. And these figures are probably too low because they are generally self-reported. Using Federal Reserve data, some researchers suggest that American households may have an average credit card debt of $12,000. At typical interest rates of 18 percent per year, that translates into more than $2,000 a year in interest payments alone."

It is significant that the situation only seems to be getting worse over time; note that the numbers are from a time *before* the global financial crisis. It might be submitted that credit card debts are soaring because that is what people prefer: they like flexibility, and they are only happy to make use of the advantages that credit cards offer. There is some truth in that, but there is reason to believe that it is not the whole truth.

Firstly, accumulating significant credit card debt seems to be inconsistent with rational financial planning (Ausubel, 1991; but see Elliehausen, 2010: 24-31). Alternative forms of credit offer better effective interest rates, so a rational actor that is planning to stay in a continuous debt of some thousands of dollars could, for example, take a small bank loan instead. As Lawrence Ausubel writes in an influential paper, "The proclivity of consumers to borrow at these high rates suggests a substantial breakdown in optimizing behavior among credit card holders" (Ausubel, 1991: 71-72).

Secondly, there are many psychological biases that operate in favor of getting into credit card debt. Salience bias implies that one tends to give too much importance to the benefits of being able to buy something right now, whereas

the interest costs are not vividly experienced, especially as many borrowers plan to pay their credit card debt in full before incurring interest payments. A closely related issue is bounded self-control: projection bias induces consumers to take too much credit (getting the benefits now, paying the costs later), and procrastination bias hinders the ability of consumers to pay their debt in full as early as possible. Empirical studies have confirmed the existence of these biases and shown that their magnitude may be very significant: according to one study, people who were buying tickets to a baseball match were willing to pay twice as much if they could pay with credit card instead of cash (see Prelec and Simister, 2001).

3.1.3 Instant Loans

New technologies such as mobile phones and the internet have permitted much faster and cheaper processing of application for small loans. This has given rise to a new category of consumer credit, often labeled *instant loans*. In terms of market size, instant loans are a marginal issue when compared to home loans and credit cards, and indeed, they seem to have attracted little academic interest.[12] However, there is growing evidence that instant loans can cause major problems for individuals.[13]

In terms of regulation, instant loans raise questions similar to earlier forms of small loans and pawn shops, but they also imply some specific problems. On the one hand, the argument in favor of contractual freedom is that small and instant loans may be valuable in some rare but real circumstances, and the pricing of such loans will be fair in a competitive market (Masciandaro, 2001; Rougeau, 1996: 16-19). On the other hand, it has been argued from times immemorial that usurious interest rates are damaging to high-risk customers who are induced to accumulate too much debt without understanding the long-term harm of such behavior (see Morris, 1988; Rougeau, 1996: 19-24). The contemporary argument for restrictions hinges mainly on the seeming irrationality of this kind of financial planning—the effective APR, taking all the fees into account, may be over 1000%—and the fact that certain cognitive biases may induce individuals to misunderstand the costs and risks embedded in the loan.

The behavioral case against instant loans is bolstered by several factors. One is the *selection problem*: instant loans and other similar services attract individuals who are already in financial trouble. Often their problems are due to cognitive and self-control deficiencies, which imply that they are especially likely to be misled by complex pricing and to overestimate their chances of paying the loan off early (we might call this the *wishful thinking bias*).

---

[12] There has recently been some discussion of other types of small loans, such as payday loans (see Plunkett and Hurtado, 2011), but they do not raise the special types of behavioral concerns associated with instant loans.

[13] In Finland, the issue has attracted significant public attention: see Jakobsson, 2008; Kaartinen and Lähteenmaa, 2006; Määttä, 2010; Valkama and Muttilainen, 2008.

The other behavioral problem with instant loans is that applying for one takes place very quickly and only requires a couple of clicks on a computer or a mobile phone. That means that *self-control problems* are increased. Further, the process is entirely electronic, so that there is no way of controlling whether someone is making the application while intoxicated – —a condition under which people are prone to make bad decisions that they regret afterwards.

One of the principal concerns with respect to instant loans is the special kind of *adverse selection* that takes place—that is, the psychological or behavioral adverse selection of the customers. Instant loans are principally used by people who are finding it difficult to take care of their personal finances; in general, they are individuals who do not qualify for credit cards (which would offer much lower interest rates). This implies that instant loan customers are such that their ability to make sound financial decisions is particularly impaired, making them prey to misleading advertising and many behavioral biases. In terms of regulation, this means that the behavioral argument for paternalism is especially strong in the case of instant loans.

3.2 Standard Responses

There are two standard responses to these concerns. One is *disclosure requirements*. According to the rational choice model, people will make better choices when they know more. The trouble is that merely requiring more disclosure may backfire—especially if the purpose of the regulation can be avoided by asking applicants to sign complex disclosure forms they do not understand, or do not have time to read carefully (Ellinhauser, 2010: 31-33). The little empirical evidence that exists demonstrates that the current systems of disclosures are far from perfect; Ellinhauser (2010: 32) summarizes as follows the rather shocking results by Lacko and Papalardo (2007) on existing mortgage disclosures in the US:

> "For current disclosures, 87 percent of participants could not correctly identify total up-front charges; 74 percent could not identify charges for optional credit insurance; and 68 percent could not identify the presence of a prepayment penalty. Participants had problems not just with terms of complex mortgages. Fifty-one percent of participants could not correctly identify the loan amount; 32 percent could not identify the interest rate; and 23 percent could not identify closing settlement charges. Responses of subprime borrowers were similar to those of prime borrowers for both simple and complex loans."

These findings suggest that many individuals are likely to make bad choices when choosing their mortgage. But the standard response is extreme—*product regulation*, for example by banning some product features. It might be claimed that people are buying into harmful contractual provisions that make no sense—

prepayment penalties, short-term ARMs (adjustable-rate mortgages) and the like—and therefore the exotic mortgages should be prohibited. But imposing an outright ban on innovative mortgages would stifle valuable innovation also, thereby harming many market participants in the long run. Seemingly unusual deals may be perfectly sensible for some individuals, such as those who are planning to sell the house in a few years. It is also unlikely that the prohibitions would be optimally specified, being over-inclusive or under-inclusive.

As a third traditional response, *usury laws* may be relevant in some cases such as instant loans, given that the effective interest rates can be staggeringly high. On the other hand, usury regulation is rarely workable in a competitive market: high prices as such are not exorbitant if they reflect risks and other costs. For example, the processing and other administrative costs of instant loans are relatively large given the small size and short time span of the loan. Moreover, price controls may simply be ineffective for such complex products as mortgages, as Willis (2006: 817) points out: "loan instruments are so malleable that any limit on one aspect of price can be evaded through restructuring the loan."

In light of behavioral economics, there may be better ways. Below I consider three broad strategies for helping consumers without taking away much or any of their freedom to choose. The first two strategies are variations of the traditional approaches (information disclosure and product regulation) but they have been adapted using insights from psychology. The third strategy (cooling-off periods) is perhaps more innovative, but it may require more development to become genuinely useful, for reasons given below.

4 BEHAVIORAL INFORMATION DISCLOSURE

The disclosure of information can be improved, but there are better ways of doing it than just demanding more of it. People often fail to correctly interpret large amounts of information, and the way the information is presented has a systematic effect on choices. The problem with disclosure regulation is that there is usually too much information that consumers cannot make use of. The final decision will often hinge on factors that financial theory would consider less important or irrelevant but that consumers mistakenly take as paramount, such as the size of monthly payments (see Barr et al., 2008: 2).

4.1 Home Loans

There are numerous possibilities for behavioral paternalism in home loan markets. Behavioral economics implies that regulations should not necessarily require so much disclosure of information, but the emphasis should be on what information is relevant and how it is presented (Camerer et al., 2003: 1230–1237). The following sub-sections look at (1) annual percentage rates (APR), (2)

standardized information sheets, (3) the disclosure of conflicts of interest, (4) ex-post disclosure standards and (5) possibilities for countering over-optimism bias.

4.1.1 Annual Percentage Rate

Rules that stipulate the calculation and disclosure of the *annual percentage rate* (APR) are a prominent example of a widespread regulatory strategy that tries to simplify complex information and make it easier for consumers to focus on the most important things and compare different offers effectively. These rules are not perfect, because there tends to be some discretion and variation on which costs must be included in the calculation of APR, and indeed there are different opinions on what is the optimal specification of APR. Nevertheless, they are a significant help to many consumers, and cause little ongoing cost to creditors (implementation costs may be higher, however).

In Europe, the rules for calculating the APR—or Annual Percentage Rate of Charge (APRC), as it is also called—have traditionally differed widely across EU member states, and some countries have not specified the matter at all (see London Economics, 2009: 168–174). Most countries have adopted a narrow APR, which covers only those costs that the lender levies for its own benefit; France alone has used a broad definition of APR, including all costs that the consumer must pay in connection with the credit (except truly optional costs).

The recent Consumer Credit Directive (2008/48/EC) has changed the regulatory landscape in Europe by demanding full harmonization of the APRC calculation method, adopting a rather broad definition (see Article 19, and Annex I).[14] That directive does not cover home loans, but a new Directive proposed by the Commission would include the same approach to home loans also (European Commission, 2011b). The principal argument for European-wide regulation of APRC is that it would facilitate cross-border markets in home loans, as it would make it easier to compare loan offers from different countries.

4.1.2 Standardized Information Sheets

The development of more innovative and complex mortgages has significantly reduced the relevance of APR alone. Indeed, according to the impact assessment of the European Commission (2011c: 11–14), many problems in home loan markets are due to difficulties at the stage before the conclusion of the contract. Advertising information is often "non-comparable, unbalanced, incomplete and unclear," while pre-contractual information can be "insufficient, untimely, complex, non-comparable and unclear."

The proposed EU Mortgage Directive (European Commission, 2011b) uses wordings that reflect an unmistakable basis in behavioral economics. The proposal includes two elements related to advertising. Firstly, there would a

---

[14] The attempt to harmonize APR specifications in the EU has a long history: see Soto (2009).

broad standard: "wording that may create false expectations for a consumer regarding the availability or the cost of a credit shall be prohibited" (Article 7). Secondly, the proposal stipulates standard information to be included in advertising: borrowing rate, annual percentage rate of charge (APRC), total amount payable by the consumer, and so on. But this is coupled with another broad standard, which demands that these items be specified "in a clear, concise and prominent way by means of a representative example" (Article 8(2)). Moreover, the standard information "shall be easily legible or clearly audible as appropriate."

In practice, one wonders whether these broad demands will have much impact. Yet perhaps the more interesting proposal for facilitating better consumer choice is the *European Standardised Information Sheet* (ESIS) (see the proposal in European Commission, 2011b: Annex II). It is an updated version of an earlier Voluntary Code of Conduct, drawn up by the Commission in March 2001.[15] According to the Commission, the implementation of the voluntary code has been "inconsistent and sub-optimal."[16] The proposal would make the use of the ESIS compulsory across the EU. Its objectives are (1) ease of understanding, as it summarizes all the important features of the contract, and (2) better comparison of different loans, making it easier for consumers to shop around. An extensive qualitative study of the proposed information sheet suggests that consumers find it helpful in terms of clarity and transparency, even if some difficulties remain (Optem, 2009).

In the US, similar concerns have been debated both before and after the collapse of the subprime mortgage sector. Willis (2006) argues that the complexities of mortgage deals, combined with the financial illiteracy of many customers, make for a toxic mix that has been ruthlessly exploited by finance companies. She submits that the most effective regulatory tools would be those that, quite simply, make it easier for potential borrowers to compare different offers and thereby facilitate shopping around for better offers (Willis, 2006: 820-828). The way to bring this about is to demand a simplified, standardized disclosure, more or less as the European Commission is now proposing. She also calls for a "chilling out" period to prevent premature commitment; that will be discussed separately later.

Some changes in this direction have been implemented in the US, too, and the Consumer Financial Protection Bureau, established in 2011, is investigating possibilities for making mortgage shopping easier. The new regulations of the Department of Housing and Urban Development (HUD) require all loan originators to issue a new version of the good faith estimate (GFE) to potential borrowers. Among other things, the new GFE is completely standardized across

---

[15] See *European Agreement on a Voluntary Code of Conduct on Pre-contractual Information for Home Loans*, http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/agreement_en.pdf.

[16] European Commission (2011b: 4; see also 2011c: 14 and Annex 4).

lenders, and it aggregates all fees the lender is charging the potential borrower into one line entitled "Our origination charge."[17] Something like that would seem to be important, because up to now, the US market has suffered from a proliferation of disaggregated fees, which in total may amount to as much as 10% of the loan value, "presumably as lenders have seen them as an opportunity to increase revenues without encountering customer resistance" (Bar-Gill and Warren, 2008: 54-55).

A more demanding proposal by Thaler and Sunstein (2009: 146–147) is to require lenders to provide a machine-readable "*RECAP report*"[18]. The report would include all the relevant data on fees and interest rates, including the role of possible teaser rates and what the changes to variable rates will depend on. This data—which shoppers would acquire from a number of potential lenders—could then be handed on to independent third parties who could offer better advice. In fact, well-designed RECAP reports might lead to the development of efficient online-shopping for mortgages.

4.1.3 Reliance and Conflicts of Interest

One concern is that unsophisticated consumer tend to make faulty assumptions to justify their reliance on their bank's advice of instead doing more personal investigation; they may assume that the bank is offering them the optimal deal, that they would not be offered the loan unless the bank thought they would be sure to pay the loan, or that in any case the regulators are protecting their interests (see Barr et al., 2008: 5). This is one of the reasons why having too much superficial regulation may have a negative side-effect: unsophisticated market participants are likely to believe that they are better protected than they really are.

On the other hand, empirically it is unclear whether consumers are so naïve about lenders. The impact assessment of the European Commission (2011c: 18) summarizes research findings as follows:

> "in the UK, 35 % of consumers do not believe that banks treat them fairly and 32 % felt that they do not trust their bank to sell them products that suit their needs. Similarly, in Belgium, one out of every three customers does not trust banks and less than 50 % of the customers felt that their bank is acting in the interest of its customers. This loss of confidence can arise in a variety of ways ranging from irresponsible lending activities to the existence of gaps in the regulatory coverage."

These figures suggest that many borrowers are not likely to trust too much their bank's advice. Lack of confidence is not, to be sure, something to be

[17] See Entitle Direct (2010) for a detailed exposition of the new Good Faith Estimate.

[18] From the words "Record, Evaluate, and Compare Alternative Prices": Thaler and Sunstein, 2009: 102.

pursued. The principal question is how to improve the conditions of loan negotiations by mitigating conflicts of interest.

In the proposed EU directive on mortgages, there is one provision to this effect. The directive tries to reduce this lack of trust principally by improving the disclosure of information, but it also stipulates some additional rules for *credit intermediaries* (Article 10). Among other things, a credit intermediary (i.e. mortgage broker) must "provide the names of the creditor(s) for which he is acting," declare his directorship and ownership rights in the creditor(s), and disclose the fee "payable by the consumer to the credit intermediary for his services." Thus the consumer would become better informed about the specific interests and incentives of the intermediary. This, in turn, might improve the incentives of intermediaries to play fair and make it easier for customers to identify untrustworthy vendors.

However, the effect of these rules is limited to credit intermediaries, and hence they do not apply to creditor as such.[19] One problem with this is that, when banks and creditors sell their mortgage deals to other investors through securitization or credit derivatives, they too are effectively acting as credit intermediaries as far as their incentives are concerned.

4.1.4 Broad Ex-post Disclosure Standards

Another concern is that the existing disclosure requirements still do not guarantee meaningful information, and effective compliance with the spirit of the rules cannot be externally verified. For example, there may be too much irrelevant information that hides what really matters, and compliance sometimes becomes a mere formality without genuine informational import: "Here's the disclosure form I'm supposed to give you, just sign here" (Barr et al., 2008: 6). Barr and others believe that these problems could be alleviated by moving from strictly *ex ante* disclosure regimes towards *standard-based ex post regulation*. That would focus on whether the disclosure was really meaningful and sufficient, using a reasonable person test (Barr et al., 2008: 6–7).

In theoretical terms this proposal is not radical, because similar principles have been developed in general contract law. For example, the English "big red hand" rule holds that if a contract term is particularly onerous, "[i]n order to give sufficient notice, it would need to be printed in red ink with a red hand pointing to it—or something equally startling."[20] What the proposed disclosure

---

[19] In the proposed directive, "credit intermediary" is defined as "a natural or legal person who is not acting as a creditor and who, in the course of his trade, business or profession, for a fee, which may take a pecuniary form or any other agreed form of financial consideration: (i) offers credit agreements within the meaning of Article 2 to consumers; (ii) assists consumers by undertaking preparatory work in respect of credit agreements within the meaning of Article 2 other than as referred to in point (i); (iii) concludes credit agreements within the meaning of Article 2 with consumers on behalf of the creditor."

[20] *Thornton v Shoe Lane Parking Ltd* [1971] 2 QB 163, per Denning LJ.

regime would do is to develop an analogous principle in disclosure regulation which, in itself, goes beyond the requirements of general contract law. Indeed, the proposed EU mortgage directive would be a step in this direction, as it stipulates that pre-contractual information must be presented "in a clear, concise and prominent way by means of a representative example" (Article 8(2)).

This approach has its problems, however (see Warren, 2006: 817-820). While a broad standard may encourage honesty, it also creates significant *uncertainty costs*. The classical common law concept of a "reasonable person" is a useful theoretical tool, but in many concrete cases its application is prone to such subjectivity that it replaces one problem with another (see DiMatteo, 1997). In light of psychology, the clarity of a contract may be easier to verify after the event, but the problem of *hindsight bias* can also distort the judgment: if a case goes to court after something has gone wrong, a boundedly rational judge is likely to infer that those events that did take place were more likely than they appeared to be to a reasonable person at the time of making the loan (see generally Rachlinski, 1998). Thus, much will hinge on external events, so that judgments will be biased in favors of lenders in good times and in favors of borrowers in bad times.

4.1.5 Countering Optimism Bias

Finally, there are disclosure requirements that are not concerned with specific contract terms but which merely warn the borrower of generic risks embedded in the transaction. For example, the US Truth in Lending Act (TILA) requires lenders to inform borrowers as follows:

> "If you obtain this loan, the lender will have a mortgage on your home. You could lose your home, and any money you have put into it, if you do not meet your obligations under the loan." (15 U.S.C. § 1639(a)(1)(B))

Under the proposed EU directive on mortgages, the European Standardised Information Sheet (ESIS, para. 14) also includes, among others, the following warnings:

> "Your income may change. Please make sure that if your income falls you will still be able to afford your [frequency] repayment instalments. *(Where applicable)* Your home may be repossessed if you do not keep up with payments."

From a behavioral perspective, such rules can be seen as attempts to counteract the ordinary *optimism bias* that most people are prone to. Highlighting risks puts people alert due to the common phenomenon of *loss aversion* (Jolls and Sunstein, 2006: 205–206). It would however be important to know how effective such statements are in reality. As Donald Langevoort (1995: 880) points out,

> "we can readily see why the law's prized warnings and disclosure will so often have relatively little practical effect, especially if they are formalized into boilerplate. Investors and consumers want to think the warnings are meant for someone else, not them."

One can imagine more effective ways of *debiasing* optimism through law (see Sunstein, 2006: 261-263). For example, mortgage offers could be combined with statistical information about the amount of payment difficulties in similar types of loans over a specified period of time. On the other hand, generalized warnings tend to be ineffective, and customers underestimate the risk that they themselves will run into payment difficulties. What might be more effective is some tailored requirement of disclosing vivid information about real cases that have gone wrong (Jolls and Sunstein, 2006: 212–216). One must ask, however, how necessary all this is, and what the costs are. Besides, we do not want to turn people into *overpessimists* (Jolls and Sunstein, 2006: 213–214).

4.2 Behavioral Disclosure for Credit Cards

In many ways, the question of behaviorally inspired disclosure regulation for credit cards mirrors the discussion on home loans. Therefore, most of the issues will not be repeated. However, there are some differences of both theory and law.

In terms of theory, the problems with mortgages are concentrated in cognitive issues (bounded rationality in the strictest sense), as home loan deals are more complicated than other forms of credit. Also the amounts of credit are significantly larger in the case of mortgages, which is another reason why that market has a stronger case for behaviorally paternalistic regulation. With credit cards, cognitive issues are also important, but it seems that many of the problems are due to bounded self-control, as some people are prone to take too much credit too easily (projection bias), and many fail to pay off their credit card debt according to an optimal financing plan (procrastination bias). These questions of bounded self-control receive more attention below in the context of default rules (section 5) and cooling-off periods (section 6).

In terms of law and legal proposals for information disclosure, the issue is much in line with mortgages. As was mentioned earlier, the EU Consumer Credit Directive (2008/48/EC) imposes a full harmonization of APRC, following a broad definition (see Article 19, and Annex I). It also sets out a compulsory Standard European Consumer Credit Information sheet (Annex II). This could be developed further along the lines of a Thaler–Sunstein RECAP report, which would consist in requiring credit card companies to

> "send an annual statement, both hard copy and electronic, that lists and totals all the fees that have been incurred over the course of the year. This report would serve two purposes. First, credit card users could use the

electronic version of the report to shop for better deals. (...) Second, the report would make more salient to users just how much they are paying over the course of the year."[21]

This information would enhance the effective comparison of different service providers. Note that, although such a report would include a lot of data, it would cost practically nothing to produce, because the companies need that data anyway for billing purposes.

Barr and others further argue that credit card users could also be assisted with compounding and timing issues, which are difficult even for many educated people. A tailored disclosure regulation would focus on salient information such as "how much long it would take, and how much interest would be paid, if the customer's *actual* balance were paid off only in minimum payments and card companies could be required to state the monthly payment amount that would be required to pay the customer's actual balance in full over some reasonable period time" (Barr et al., 2008: 13). The provision of such information would be practically without cost, yet it might help financially unsophisticated consumers to focus on relevant facts.

4.3 Instant Loans

Instant loans are very similar to credit cards in terms of information disclosure, with the one practical difference that the effective annual percentage rate (APR) tends to be very high—even thousands of percents—for small loans, given that the administrative costs are so large relative to the loan amount. One interesting feature of the EU Consumer Credit Directive (2008/48/EC) is that, in addition to imposing standardized APRC calculations, it requires companies to provide a representative sample calculation in their advertising materials. Also, it is worth noting that the Consumer Credit Directive does not cover amounts below 200 euros (Article 2(c)). However, some countries, including Finland, have implemented legislation which omits this exclusion (see Finnish Consumer Agency, 2009).

It was explained earlier that the primary marketing target group of instant loans is such that the borrowers are likely to be financially incompetent. This implies that regulatory methods focusing on financial figures may be rather ineffective, or at least less effective than in other contexts such as credit cards. On the other hand, interventions aiming to reduce overoptimism bias—for example, by way of alarming anecdotes and personal stories—might be a worthwhile idea in this context.

---

[21] Thaler and Sunstein (2009: 148–149). Similar price disclosure regulations can be found in other areas: for example, mobile phone operators in Finland are required to provide a detailed monthly breakdown of usage costs, including duration and total cost of calls to different operators; number and total cost of text messages to different operators; duration and cost of receiving calls abroad; and any other expenses. Unfortunately, the report is not electronic—that would be a major improvement.

5 OPTING OUT: DEFAULT RULES

The problem with ordinary product regulation is that it tends to go from one extreme to the other—from freedom of contract to restrictions and prohibitions. In light of behavioral economics, a more nuanced policy may sometimes be better. Using default rules with the possibility of opting out, the law may be able to help people make better choices without fundamentally reducing contractual freedom.

In neoclassical economics, default rules are a way of reducing transaction costs. The behavioral approach accepts this but adds something different.[22] On the one hand, the *status quo bias* suggests that people tend to stick with default options unless the alternatives are clearly better. The *anchoring heuristic*, on the other hand, implies that even if a departure is made, it is usually "anchored" to the default rule, that is, it will differ less than without any starting point.[23]

5.1 Default Home Loan Design

With home mortgages, one could imagine a default mortgage deal (a "plain vanilla" mortgage)—or even a small menu of such mortgages—which would be specifically designed by an independent third party so as to avoid any hard-to-understand details or complex interest rate calculations that exploit common psychological biases (see Barr et al., 2008: 8–11). The potential advantages of this approach are numerous. Such simplified mortgages would be easier to compare across different offers, reducing transaction costs to unsophisticated shoppers and improving the quality of their choice. They would hinder dubious innovation, because most people would at least anchor their choice to the default option, which would be relatively simple and safe by design. The default rule would also function selectively in the sense that it would be especially relied on by unsophisticated customers, who feel uncertain about taking a mortgage. In contrast, sophisticated shoppers would be free to explore other options. Importantly, the "plain vanilla" mortgage would permit opting out, which may be entirely reasonable if, for example, someone's circumstances or preferences clearly differ from the standard assumptions—or if the default mortgage is poorly designed (I will come back to that in section 7).

There are several questions that would have to be answered in designing a default mortgage (or menu of mortgages). The fundamental variables include the loan term and the interest rate determination of the mortgage. The issues are

---

[22] See Korobkin (1998a, 1998b, 2000) for extensive general discussions on default rules in light of behavioral economics.

[23] There may also be other reasons for the strength of default rules. For example, default rules will mean more certain legal outcomes if there are interpretation problems faced by imperfectly rational judges. See La Porta et al. (1998: 1121).

complex, but the basic question is: What would an average consumer prefer if he were capable of making an optimal choice? Some answers could be gathered from finance theory, and the default mortgage could be periodically revised by a relevant regulatory body, for instance using statistical and survey research.

As an example, the longer the loan term, the larger the total interest paid. But this tends to be ignored by consumers who focus on the size of monthly payments, so the default rule should stipulate a relatively short loan term. This would implicitly discourage too sizeable mortgages also.

As to interest rates, mortgages in many European countries are predominantly tied to variable short-term rates (such as the LIBOR or the EURIBOR). In the US, fixed-rate mortgages (FRMs) have become the standard, but complex adjustable-rate mortgages (ARMs) have caused problems in recent times, and generally consumers do not seem to understand correctly under what conditions one alternative is better than the other (Campbell, 2006: 1577-1580).

Variable or adjustable rate mortgages may sometimes be the better or the only option, but generally they contain disadvantages to consumers. Firstly, they are unlikely to imply an *efficient allocation of risk*. Due to economies of scale, banks are better able to bear and hedge interest rate risk. They also have better access to relevant knowledge and expertise in order to make an accurate risk assessment. Secondly, consumers tend to be ignorant of the significant likelihood that *short-term interest rates will change* considerably over the lifetime of the loan, so that they underestimate the risk of rapidly rising interest costs. Thirdly, from a consumer viewpoint, unhedged interest rate risk also tends to coincide with *macroeconomic downturn risk*, which means that one ends up paying more while being more likely to be unemployed.[24] Fourthly, complex ARMs often cause *error costs*, which consumers tend to pay without noticing.[25]

The details of a generally optimal mortgage are somewhat disputed, but the consensus seems to favor either fixed rates, or variable rates indexed to inflation. Reviewing the literature, Miles (2004: 91) concludes that variable-rate mortgages (or ARMs) are riskier in terms of default probabilities, as they are more sensitive to both interest rate risk and changes to factors such as payment-to-income ratios. Miles' model results support this opinion, finding that under most specifications, households should prefer a very long fixed-term mortgage (Miles, 2004: 15). Campbell (2006: 1586) also writes, summarizing earlier literature that "economists have often recommended mortgages that adjust interest and principal payments for inflation, thereby combining the best features of nominal FRMs and ARMs," while more recently some "have proposed an automatically

---

[24] On the issue of personal macroeconomic risk management, see Shiller (2004) for an extended discussion.

[25] A 1995 study by the Federal Savings and Loan Insurance Corporation (FSLIC) found that 50–60% of all Adjustable Rate Mortgages in the US contained an error regarding the variable interest rate charged to the homeowner. The estimated total amount of interest overcharged to borrowers was over $8 billion. See Renert (1995).

refinancing nominal FRM that would eliminate sluggish refinancing and also save consumers' considerable costs of current refinancing procedures."

Given the theoretical criticism of typical variable rate mortgages, one wonders why they are so common. In the UK, one quarter of mortgages are have a fixed rate, but of only 2–3 years (which really means that it is more like a variable-rate mortgage); as few as about 2% of all mortgages are fixed for more than 5 years. Miles (2004: 17-21) discusses three hypotheses that could explain this, and concludes that the only convincing explanation is the psychological one, that is, "imperfect understanding of risks and of the likely profile of future interest rates, a tendency to focus on initial payments on mortgages, and a pricing structure that plays to that tendency" (p. 21).

In other words, behavioral economics would tell us that the use of variable rates makes it extremely difficult—impossible, really—for non-professionals to calculate the likely total cost of the mortgage. Given that the risks of variable rates are largely hidden (not salient), and that consumers tend to give too much importance to initial monthly payments, the market will in times of low short-term rates be biased in favor of variable rates—especially if there is an even-lower "teaser rate" at the beginning of the loan (Campbell, 2006: 1588; Miles, 2003).

Further, it turns out that disclosure rules may also influence the choice between fixed and variable rate mortgages. Miles (2004: 38-40) explains that in the UK (where there is practically no market for long-term fixed rate mortgages) the APR is calculated under the assumption that interest rates will not change during the life of the loan. But in times of expected increases to interest rates (an upward-sloping yield curve), the APR will understate the real expected costs of the mortgage, and unsophisticated consumers will only pay attention to the APR in comparing different offers. That causes a suboptimal bias towards variable rate mortgages when the spot rates are low. As a partial solution, Miles (2004: 39) submits that "[a] potentially more informative measure of APR could be calculated based on expected interest rates over the life of the debt. This would provide a better figure for comparing the likely cost of variable-rate mortgages with fixed-rate mortgages; it could be used instead of, or in addition to, the standard APR. Such a figure could be based on the forward rates implied by the yield curve." However, the costs of providing such APR figures might be significant, and it also might cause more confusion to consumers, as there is evidence that they already misunderstand the meaning of APR figures.

The issue is even more complicated. In an efficient market, variable rate mortgages may be cheaper on average, because borrowers bear the interest rate risk. For this reason, some commentators have argued that variable rates are the better choice for many consumers (Milevsky, 2001).[26] In terms of regulation,

[26] Note however that Milevsky's study uses Canadian data in which the "fixed rate" refers to a 5-year mortgage rate. That reflects the fact that longer fixed rate mortgages are not available in all

contentious matters could be overcome by a compromise solution, for example creating two different "plain vanilla" mortgages, one variable and one fixed rate (perhaps labeled "riskier" and "safer" respectively, so as to nudge in favor of the latter). The former should in any case avoid any complex mechanisms—such as teaser rates and bullet or balloon payments—that confuse unsophisticated customers and exploit cognitive quirks.

It may be argued that the approach taken here is still too simplistic: it is not sensible to create any standard design, because people have different preferences. That criticism should not be accepted too easily, because people's risk preferences and house purchase plans do not differ very much, and even a simplistic default rule would serve as a useful anchoring device for less sophisticated buyers. On the other hand, the critique points towards innovative improvements. Namely, it may be possible to develop "smart defaults," such as a standardized formula that creates a *customized default mortgage* based on key borrower characteristics, including age, income, family situation, and other personal finance factors (see Barr et al., 2008: 10–11). Indeed, it seems likely that the optimal "safe and simple" mortgage depends on many factors, such as whether one is buying the first home as a young father of many children and no savings, or acquiring a house in the country for retirement purposes. Note, for example, that Milevsky (2004) finds that, even if a variable rate is often better according to his model, a first-time homebuyer should nevertheless lock in at a fixed rate.

One concern is that the default mortgage contract would have little effect in practice if there are strong incentives for lenders and brokers to provide different deals. However, there are many implementation possibilities. In one extreme, it would be compulsory for lenders to lay out the default deal in all its detail before presenting alternative offers. This would increase the salience of the default plan and create a strong anchoring effect with respect to the alternatives. The disadvantage is that transaction costs would be increased for those who are only interested in the other offers. On the other hand, if the default mortgage strategy is adopted along with the RECAP disclosure regime (discussed earlier), and if online mortgage shopping emerges as a result, then transaction costs of taking a mortgage are reduced, too.

---

markets. Campbell (2006: 1586) argues that the existence of different standards across countries is puzzle that is probably due to the existence of unsophisticated consumers: "unsophisticated households tend to use whatever financial contracts are standard in a particular country, possibly because they follow the lead of relatives and neighbors. It is expensive for would-be financial innovators to reach such households, particularly if they need to explain a complex new financial product." Furthermore, the incentives to offer new products to sophisticated clients may be weak, because "existing products often involve a cross-subsidy from naive to sophisticated households. A refinanceable FRM, for example, offers a low rate in part because many households do not optimally refinance. Sophisticated households gain by pooling with naive households, and will not be attracted to a new mortgage if it is only taken up by other sophisticated households."

Barr and others have speculated with the idea of making the default rules "stickier" by imposing different interpretative principles applicable to default and alternative contracts, so that the latter would imply additional legal exposure for lenders through increased scrutiny (Barr et al., (2008: 8–11). How that might work in practice is difficult to tell, but in principle there is nothing unusual about a law that combines narrow rules and broad standards. On the other hand, it would be useful to test the idea in a simpler fashion before adding complications that may not be needed.

5.2 Default Credit Card Rules

Something similar could be developed for credit cards. It has been argued that credit card product offerings are systematically designed to exploit common behavioral biases (Bar-Gill, 2004). Many consumers underestimate how much they will borrow and overestimate their ability to pay on time. Credit card bills may also encourage the accumulation of debt by highlighting the minimum payment, which then serves as an anchor even though it is normally just a small proportion of the total bill. The pricing of credit cards is moreover set to benefit from late payment, creating an incentive for companies to try to get their clients deeper into debt (Mann, 2007).

A possible help to consumers—at least to those who are subject to bounded rationality and bounded willpower—would be to develop suitable default rules (Barr et al., 2008: 13–15). These would govern all credit card contracts except those in which the customer specifically chooses otherwise. For example, the default contract would be simple and straightforward, with no teaser rates and other complications. It would also require consumers to pay off their existing balance automatically in a short period of time.

The law could also require that all credit cards allow clients to set up automatic payment of the entire bill; many credit card users could pay it in full, but tend to forget or ignore it and end up paying high interest (see Thaler and Sunstein, 2009: 149–150). Some creditors allow the automatic payment of the entire bill, while others permit you only to pay automatically if you pay the *minimum* amount. The latter case is sub-optimal from a behavioral point of view, because it prevents behaviorally astute borrowers from opting into bias-reducing devices.

People may have very different situations and preferences, and the law should not restrict their freedom to choose what suits them best. A well-designed default credit card would, however, help many consumers by providing a safe and simple card. It would also serve as an anchor that hinders going over the top with exotic features. As with mortgages, the possibility of developing "smart defaults" is also worth investigating.

5.3 Default Rules for Instant Loans

Default rules may not be so relevant in the case of instant loans, because the terms of such loans are already quite straightforward. Moreover, the nature of the market is such that the lenders tend to use standard-form adhesion contracts, because the small size of the loans would make individual negotiations prohibitively expensive. Therefore, if regulation is deemed necessary to avoid abusive contract terms, it is probably necessary to resort to stronger forms of product regulation, not default rules.

6 COOLING OFF

Cooling-off periods play an important role in consumer protection laws (Haupt, 2003: 1147–1151). There are at least three broad justifications for them (Haupt, 2003: 1147–1148, and references cited therein). One is *informational asymmetries*, especially in distance transactions (where prior inspection is impossible) and in connection with so-called experience and credence goods and services (which cannot be properly evaluated before use). The second justification is *situational monopolies* such as door-to-door selling where consumers are wrongly brought to believe that seeking alternatives would be too costly (Sunstein and Thaler, 2003: 1188). Thirdly, cooling-off periods may be helpful if problems are caused by *lack of self-control* and appropriate rational deliberation (see also Camerer et al., 2003: 1238–1247).

There are thus different possible justifications for cooling-off periods, ranging from standard economics to behavioral economics. Thus, Sunstein and Thaler (2003: 1188) write that

> "mandatory cooling-off periods make best sense, and tend to be imposed, when two conditions are met: (1) people are making decisions that they make infrequently and for which they therefore lack a great deal of experience, and (2) emotions are likely to be running high. These are the circumstances—of bounded rationality and bounded self-control respectively—in which consumers are especially prone to making choices that they will regret."

In consumer protection laws, cooling-off periods normally take the form of *withdrawal periods* or *cancellation rights* within a specified time period. In economic terms, these can be called *ex post* cooling-off periods. There are also *ex ante* cooling-off periods, i.e. *waiting periods*, during which the transaction cannot be finalized.

In practice the difference between *ex ante* and *ex post* regulations may be small, but generally waiting periods are more intrusive. On the other hand, *ex ante* waiting periods may sometimes be better for sellers in that there is no risk

of *ex post* opportunistic behavior. Note also that, in light of status quo bias and the endowment effect, waiting periods are likely to have a stronger behavioral effect than withdrawal periods, because people are reluctant to withdraw from a trade they have already entered into, especially if they are in possession of the good or benefit (Haupt, 2003: 1149; see also Kahneman, Knetsch and Thaler, 1990, discussing empirical evidence on the endowment effect).

6.1 Home Loans

Cooling-off periods are not common in personal finance regulation, but some examples can be found in existing laws. In light of the two criteria of Sunstein and Thaler (2003: 1188), cooling-off periods in taking a mortgage would seem justified on the basis of infrequency and lack of experience, and it is possible that many imprudent borrowers have been heavily influenced by transitory emotions provoked by a personal financial crisis or a manipulative salesperson.

Commentators such as Willis (2006: 823-824) have argued for more extended chilling-out periods for mortgages. She points out that a cooling-off or chilling-out period is an important *accompaniment to behaviorally-motivated disclosure rules*, because consumers need time to consider the offer and shop around. Also, there should not be significant application fees, because otherwise people will be reluctant to shop around and may become psychologically committed to the first offer due to loss aversion bias. To further encourage detachment from the initial offer, Willis even proposes an explicit pro-shopping declaration in the mandatory disclosure sheet:

> "My proposed language is: 'It is possible that this loan is not the lowest priced available. This paper is the Price Tag for this loan. You should use it to shop with other lenders or brokers for the best loan at the best price, just as you would for any major purchase.'; and a non-too-subtle double entendre, '*Time to go shopping!*'" (Willis, 2006: 824, footnote 462)

Note that the *regulation of application fees* is a kind of *ex post* right-of-cancellation regulation, and it influences the extent to which consumers are committed to the deal from the start. Another *ex post* cooling-off rule is the *regulation of refinancing or early repayment*: if borrowers can opt for a new deal without incurring significant penalties, they are effectively enabled to cancel the original deal.

In Europe, the proposed EU mortgage directive (European Commission, 2011b) includes some features related to cooling off. Perhaps the most interesting of them is the broad *ex ante* cooling-off standard in Article 9(2) of the proposal:

> "Member States shall ensure that when an offer binding on the creditor is provided to the consumer, it shall be accompanied by an ESIS. In such

circumstances, Member States shall ensure that *the credit agreement cannot be concluded until the consumer has had sufficient time to compare the offers, assess their implications and take an informed decision* on whether to accept an offer, regardless of the means of conclusion of the contract." (Emphasis added)

In terms of *ex post* regulation, article 18 requires that member states provide consumers with a right to early repayment; the exercise of this right may be subject to certain conditions, and creditors should be entitled to fair compensation, but these conditions must not render the exercise of the right "excessively difficult or onerous for the consumer". Further, in accordance with the earlier Doorstep Selling Directive (85/577/EEC), consumers "should have a right of withdrawal for credit agreements relating to residential immovable property concluded off-premises and should be informed about the existence of that right" (European Commission, 2011b: preamble 13).

In the US, the Mortgage Disclosure Improvement Act 2008 tries to improve consumer choice through a strict *ex ante* cooling-off rule known as the "3/7/3 Rule." Within three business days after receipt of the loan application, an initial good faith estimate (GFE) disclosure must be provided. Next, a seven business day waiting period follows during which the borrower is not permitted to close. Finally, the borrower must receive an accurate annual percentage rate (APR) calculation at least three business days prior to closing. If the final APR is off by more than 0.125% from the initial GFE disclosure, then the lender must re-disclose and wait another three business days before closing on the transaction.

It would be interesting to see an empirical study of how, if at all, these rules have influenced behavior, and what the costs are. Also, if the proposed EU directive is approved, empirical comparative studies would be very helpful for better understanding the effects of different approaches.

6.2 Credit Cards

With credit cards, self-control problems may be one factor contributing to the accumulation of credit card debt. If that is correct, then cooling-off regulations might be relevant. On the other hand, the issues of complexity and infrequency are not so much present in this context, so the case for cooling-off is weaker than with mortgages.

The principal challenge to cooling-off rules with credit cards is a practical one, because it is not clear how to design a cooling-off regulation that effectively mitigates problems without creating significant costs. Typically there are general consumer-protection type withdrawal-periods applicable to credit card loans, but they have little practical relevance, because credit card debt is taken at the moment of purchase, and some purchases cannot be cancelled because the goods in question are immediately consumed. In other cases, when the purchase

can be cancelled, the endowment effect tends to reduce the likelihood of people going back to the shop and returning the product.

Compulsory waiting periods would have a stronger effect, but they would create significant transaction costs—at least psychic costs—because the principal advantage of credit cards is that they enable consumers to buy something with credit on the spot. And if the waiting period is very short, then the effect evaporates.

What might be worth investigating is the use of *customized controls* to credit card usage. These customized limits could be set or re-set by the card user, or by other relevant persons, such as a young person's parents, or spouses together. The limits could be determined on the basis of purchase type, amount, and timing. For example, a person who has alcohol problems could set limits on the amounts of alcohol or related products that can be bought with the credit card. Likewise, night-time purchases could be limited or prohibited, or made subject to a waiting period. There may be some practical challenges, but the development of technology would help to overcome them.

In terms of paternalism theory, this kind of voluntary mechanism would not be a question of forcefully limiting the freedom to choose; rather it is an example of facilitating the provision of self-control mechanisms whereby imperfectly rational and imperfectly self-controlled actors can *opt into bias-reducing devices*. Such mechanisms may, of course, be provided by the market without any regulatory intervention. The case for regulation hinges of the argument that lenders may not have sufficient incentives to develop such services, because they profit significantly from borrowers who have difficulties controlling their use of credit, while the benefits (in terms of customer loyalty) of better service may be small.

6.3 Instant Loans

In the case of instant loans, cooling-off regulations may be especially justified in light of self-control problems. In this case, as with credit cards, an *ex post* right of cancellation exist as part of general consumer protection laws. It turns out that this is economically problematic, because it enables *opportunistic behavior* by borrowers (assuming that they know their legal rights).

According to the statutory consumer protection laws that are in place in many countries, early repayment or loan cancellation has to be compensated to the lender in accordance with the APR of the loan contract. The APR is higher if the contractual loan period is shorter and lower if the loan period is longer, because the APR includes the fixed administrative fees. The result is that if one wants to take a very short-term loan, it is better to take a longer-term instant loan, cancel it within the cancellation period (14 days in many countries), and repay the loan together with the relevant interest after the statutory repayment

period (usually 30 days).[27] The compensation for the cancellation and the repayment delay is only the APR of the initial contract. The result is a loan of more than a month, but with an APR corresponding to a longer-term contract.

Ex ante waiting periods may be more relevant in terms of helping people avoid getting imprudently into debt. Naturally they cannot be very long without entirely transforming the concept of instant loans. One option is to target the waiting period to specific problems such as night-time drinking. In Finland, for example, a consumer loan applied for between 11pm–7am can only be received after 7am.[28]

Another possibility—which could be used either separately or in conjunction with the night-time waiting period—is a minimum waiting period of 1–2 hours at any time; during this time period the borrower could also receive notification of the principal costs and risks of the loan. A further modification that could be added is that the loan agreement would have to be specifically confirmed by the consumer after the waiting period (as opposed to a right to cancel the loan during the waiting period); this might reduce the psychological commitment as the default rules would be such that the loan is cancelled if it is not expressly confirmed.

Personalized or customized borrowing limits might also be useful, but their implementation would be more complicated. Given that the market for instant loans is generally not based on longer-term contracts, this kind of arrangements would probably cause relatively high costs.

7 CRITICISM AND IMPROVEMENTS

Paternalistic proposals inspired by behavioral economics have met with a range of criticism. Some commentators argue that the behavioral approach is too flawed and obscure to yield a workable analytical model (Posner, 1998). Some go so far as to claim that the supposed mistakes made by people are not really mistakes at all (Mitchell, 2002, 2003). Others accept the critique of neoclassical economics at least in part, but disagree on the policy implications (Glaeser, 2006; Klick and Mitchell, 2006). In what follows, I will try to address some of the more plausible criticisms and discuss some general ways in which behaviorally paternalistic policies might be improved.

---

[27] See for example Finnish Consumer Protection Act 7:20.

[28] Consumer Protection Act 7:19. Määttä (2010: 277) points out that a bright-line rule like this one may be both *over-inclusive* (some borrowers may reasonably need the money at night) and *under-inclusive* (some may unreasonably apply before 11pm, or indeed be intoxicated during the day). However, it is not possible to create a workable flexible standard in this case. See more generally Kaplow (2000).

7.1 General Criticism of Paternalism

The claim that behavioral economics is entirely unfounded is hardly plausible (see Rachlinski, 2003, for a detailed discussion). There are, however, many important general arguments against paternalistic regulation.

One criticism, addressed particularly against Cass Sunstein and colleagues, is that it is conceptually misleading to talk about *"libertarian paternalism"* (Hill, 2007; Mitchell, 2005). While it may be the case that sometimes paternalistic policies are good, they always imply that the regulators know better what people need, and they always limit personal autonomy in some way. Sunstein and Thaler (2003: 1171) try to argue that paternalism is "inevitable" because there are always default options and framing effects; but the examples they provide are hardly convincing. In practice, only a small proportion of behaviorally inspired paternalistic policies are somehow inevitable. Therefore, the notion of "libertarian paternalism" is problematic, whereas "behavioral paternalism" seems more accurate, because it builds explicitly on the idea that people make mistakes and they may need assistance in order to choose better.

A second issue concerns the *ability of people to learn* to avoid their mistakes, to adopt behavioral strategies for mitigating mistakes, and to delegate decision-making to persons equipped with better judgment (Epstein, 2006; Rachlinski, 2003). This is a major issue, which has already been touched upon earlier to some extent. The difficult task is that of identifying when and how people learn to choose better and whether they are able to look for the right assistance. In any case, this is not really an argument against behavioral paternalism as such. Paternalism may be practiced in the private sphere, too, and public intervention may be needed to correct lack of learning and inappropriate delegation of decision-making. For example, in home loan markets people often delegate some of the judgment to the bank or mortgage broker; but this is usually not the ideal arrangement because of strongly conflicting interests.

Thirdly, some commentators have raised the concern that behavioral paternalism will result in a flood of new regulations, which seem light and low-cost when considered in isolation, but which together impose a significant regulatory burden (Ginsburg and Wright, 2012; Whitman and Rizzo, 2007). This *slippery slope argument* is not mere scaremongering, but is a valid concern. The legal interventions proposed earlier have the disadvantage that they may seem so harmless and innocent that they might be accepted "too easily." Indeed, one of the big questions in relation to behavioral paternalism is whether it is used (a) to design lighter and cleverer regulations to replace heavier and clumsier ones, or (b) to justify new regulations where none existed before.

A fourth general concern is that the *empirical facts* in support of behaviorally inspired paternalism are uncertain in many cases, and that its advocates are exaggerating or misrepresenting those facts (Wright, 2007). An interesting example is the debate that has ensued over the rationality of credit card use. Behavioral economists have often used credit cards as a typical example of

people making suboptimal borrowing choices, misled by attractive features and complex interest rates (Bar-Gill, 2004; Loewenstein and O'Donoghue, 2006: 196-198). However, recent empirical studies have challenged the validity of these concerns. One study looks at the issue of so-called hyperbolic accounting and claims, contrary to behavioral economics, that most people choose their credit card optimally and are not misled by the difference between short-term and long-term rates in some credit cards (Brown and Plache, 2006). However, another study, using a market experiment with two credit card contracts, finds that a substantial fraction (about 40%) of the people choose the suboptimal card initially; many of the initial mistakes were corrected later, but a small minority of consumers persisted in holding substantially suboptimal contracts (Agarwal, Liu, Souleses and Chomsisengphet, 2006).

Sunstein writes in defense of paternalism that "objections to paternalism should be empirical and pragmatic, having to do with the possibility of education and the likely failure of government response, rather than a priori in nature" (Sunstein, 1997: 1178). However, the problem is that the notion of "empirical" is vague, and it is not clear that critics of paternalism should always have the burden of proof. One could argue in contrast that, when clear empirical knowledge is lacking, anti-paternalism is justified.

7.2 Overstating Benefits, Understating Costs

Some degree of general or *a priori* skepticism towards paternalism may be justified, because we tend to overestimate the benefits of regulation and underestimate its costs. There are at least three reasons for this, supplied by cognitive psychology. Firstly, the *availability bias* implies that we tend to give too much importance to existing problems, while we discount the unforeseen costs of trying to solve those problems. The traditional theory of markets and regulation shows that regulatory intervention creates many hidden costs, including *non-measurable costs* (psychic or subjective costs) and *dynamic costs* which are caused as regulations lag behind new developments and impose obstacles to value-adding innovations. Whereas the benefits of resolving a problem are easy to image, these hidden costs are not salient and will tend to be ignored.

Secondly, the *overconfidence bias* means that most people—experts in particular, including legal scholars and regulators—are likely to overestimate their ability to come up with good solutions to social problems. In reality, many regulations do not work the way they were supposed to, and even excellent ideas tend to become less perfect when they go through the complexities of the political process. Scholars should be aware of this, especially when they propose highly intrusive and costly policies.

Thirdly, the *overoptimism bias* implies that when we are excited about an interesting theory, we are likely to place too much hope in it. It should be remembered that the adaptive behavior of individuals and firms may render

nice ideas less effective in practice. Regulated firms will try to avoid costly regulations, just as has happened so many times earlier, for example with compulsory disclosure rules. Consumers, too, may change their behavior from bad to worse as a result of too protective regulations (Klick and Mitchell, 2006).

One can think of several examples to illustrate the problem. For instance, Sunstein and Thaler (2003: 1187–88) are highly optimistic about the advantages of cooling-off periods, but they fail entirely to consider *both* the indirect costs of cooling-off *and* the different ways in which this type of regulation may become ineffective as people adapt their behavior.

Likewise, the proposals for "debiasing through law" do not seem intrusive, but in practice they can be costly, the benefits are uncertain, and they can have a range of negative side-effects. Jolls and Sunstein (2006: 208–209) acknowledge that optimism bias is context dependent: people do not always fall into it, and in fact, sometimes people are *excessively pessimistic*. For example, right after a vivid crisis, people overestimate the risks of investing, of air travel, of nuclear energy, and so on. It will be difficult to design well-targeted debiasing laws, given that law-makers have limited information, law is a crude and clumsy instrument, and changing the law is time-consuming and difficult.

Another problem with debiasing through law is that, unlike asymmetric paternalism, the strategy does not distinguish between *heterogeneous actors* (see Rachlinski, 2006). Jolls and Sunstein (2006: 229) correctly point out that trying to reduce optimism bias through a strategic use of the availability heuristic may "distort the behavior of individuals who did not suffer from optimism bias in the first place. For those who previously had an accurate understanding of the situation, such strategies for debiasing through law could produce a kind of unrealistic pessimism."

These concerns do not mean that behavioral paternalism cannot work—only that we should be wary about taking it too far. In practice, this prudent caution may be shown in requiring more empirical evidence of specific problems before launching into solving non-issues. It can also mean that paternalistic regulations should first be tried in a preliminary fashion as local experiments (this would be easy in federal states). The initial experiments would provide valuable feedback, which could be used for *ex post* impact assessment (in light of overconfidence and overoptimism, *ex ante* impact assessments are of limited value). Even if it turns out that the original plan was great, it could probably be still improved in some way.

A different way of putting the same principle is that *decentralized policies* may be optimal, when there are likely to be complex dynamic costs that cannot be easily predicted. An interesting case that merits critical discussion is the regulation of APR in the European Union: centralization of APR calculations has its advantages, but it may also reduce vital debate on the best way of defining the APR. The definitional question is not without importance, because (as was explained earlier), it has been argued that the current mortgage APR

calculations, which assume that interest rates will not change during the life of the loan, tend to understate the real expected costs of the mortgage (Miles, 2004: 38-40).

Note also that different regulatory strategies have different implications for regulatory failure. Generally, the more intrusive the regulation is, the greater the need for caution. For example, *ex ante* cooling-off periods are significantly more intrusive than *ex post* rights of cancellation, and therefore demand stronger justification. With respect to information disclosures, the costs can vary greatly depending on what is demanded of lenders. On the other hand, default contract designs have the advantage that the regulatory costs are probably not significant even if the default rule is very poorly designed; markets may simply ignore the default option (there is a small increase in transaction costs, of course). Note, however, that if most customers choose to ignore the default deal, regulators ought to have the humility to admit their mistakes—not to conclude that people do not know how to choose and therefore the opt-out deal must be made compulsory.

7.3 Finding the Right Balance and Combination

Regarding ways of improving paternalistic regulations, it was mentioned earlier that some authors have proposed making the default or opt-out mortgage or credit cards deals "stickier" through creative legal standards (Barr et al., 2008: 8-11). A couple of further points on this are in order. For one thing, it should be remembered that we need to look at the *combination of legal strategies* that will or can be adopted, not just any one of them in isolation. For example, cooling-off periods may be applied selectively to some deals and not others, thereby strengthening the attraction of the former. One possibility among many is to impose a short waiting period for non-default proposals, as this would encourage consumers to consider these offers more carefully.

On the other hand, it should be borne in mind that people may ignore the default contract design, not because there are harmful market pressures and the default plan is not sticky enough, but simply because it is badly designed. The upshot is that the opting-out strategy may fail in different ways, and one should enquire into the causes before changing the system. Again, local trials would facilitate better discovery of good solutions.

A related issue is that behavioral paternalism may result in too detailed regulations, which become overly rigid and unable to adapt to changing environments. That is a valid concern generally, and an argument for *broader standards* (see Kaplow, 2000). However, as far as default or opt-out regulations are concerned, rigidity is less of an issue than in the case of compulsory rules, because market participants will be free to ignore the default rule if it becomes significantly outdated. Moreover, the rules could in any case be updated using survey data. The idea of "smart defaults" or customized opt-out deals should

also be considered as a way of reducing unnecessary rigidity (Barr et al., 2008: 10–11).

7.4 Beyond Government

Another question that has been touched upon at various points is whether government is the most suitable actor for influencing private decision-making. The issue merits further reflection. An interesting point about the popular book by Thaler and Sunstein (2009) is that almost all the examples of positive "nudging" that the authors supply are taken from the private sector. The authors go on argue that the same approach should be adopted in the public sector, and certainly that may be correct. There are, however, important differences between public and private actors, which influence their ability to design helpful and efficient nudges.

The fundamental advantage of private sector solutions for "nudging" or "debiasing" is the same as the advantage of market-based solutions in general (see Hayek, 1949; Kirzner, 1973, 1997). Markets are driven by entrepreneurship and hence rely on *competition as a discovery procedure*. The *price system* provides fast and detailed information to producers about the value added in different productive options, and private actors taken together have a vast amount of *decentralized information* that cannot be easily collected and summarized in statistics. Further, the ability of entrepreneurs to try many new things, and learn through a *process of trial and error*, makes market-based solutions enormously more capable of coming up with new solutions and improvements to earlier methods. In contrast, governmental actors do not receive quick feedback on how well they are doing; they have weak incentives to try new things and change policies that are not worthwhile; they lack crucial information about private needs and preferences; and their ability to try out new things is always hampered by the complexity of the political and bureaucratic processes which dominate public sector activity.

The implication is not that governmental regulation is never advisable. It is rather that the first question is whether it is possible to *improve the incentives of private sector actors* in such ways that they will want to come up with helpful (rather than unhelpful) nudges and such like for improving consumer decision-making. In other words, before jumping into the conclusion that governmental regulation is necessary, one should also enquire into the workability of market-based—and civil society-based—solutions. If these work, they tend to be more flexible and adaptable, and less costly for companies to comply with. There are several interrelated issues here, including the incentives of firms, industry self-regulation, and the role of civil society.

Sometimes regulation is not needed, because firms have the incentives to develop similar solutions freely—but perhaps they have not yet discovered the profit potential of helping consumers better. It is difficult to say anything general about the incentives of firms in this regard: that depends on the firm, the

customer segment, the reputational benefits, the relevant time-horizon and other factors. On the one hand, the interests of lenders and borrowers may be poorly aligned, and the former will have an incentive to exploit the biases of the latter (Barr et al., 2008: 3-4). On the other hand, some lenders—for example banks of the more conservative type—may have the incentive to develop the kinds of mechanisms that have been discussed in this paper (well-designed default contracts, better and clearer information disclosure and so on), because that would give them a competitive advantage over so-called rogue dealers.

These incentives of certain lenders may be insufficient to reform a poorly-functioning market—assuming one exists—but they are nevertheless relevant for seeing the bigger picture correctly. For one thing, this implies that there would be more political support for paternalistic regulations than otherwise, because some members of the industry would welcome such policies as being helpful for their business too. For another thing, it means that industry self-regulation could evolve in order to coordinate the strategy of conservative lenders and reinforce the reputational benefits of providing more cognitive-friendly services. An alternative approach is enforced self-regulation (or co-regulation), whereby industry associations would be required to develop a self-regulatory plan, which would then be approved by a public agency and reviewed periodically. The industry motivation for coming up with a good proposal could be fostered by the threat of command-and-control regulation as the alternative.

Finally, industry initiatives and governmental regulation can be combined with the activities of civil society groups such as consumer associations. Such organizations could play a role in developing services that firms do not offer. For example, consumer associations could provide guidance and recommendations for their members, and they could also be empowered to do so better through legislation. Moreover, behaviorally-designed information disclosure regulations would facilitate the provision of additional services, not only by markets but also by relevant civil society groups.

8 CONCLUSION

Behavioral economics provides an interesting case for a new type of paternalistic regulatory policy, labeled here behavioral paternalism. This paper has clarified the notion and theoretical underpinnings of behavioral paternalism, and examined its relevance and prospects in the context of consumer credit regulation, looking especially at the markets for home loans, credit cards and instant loans.

It has been found that some existing aspects of consumer credit regulation are best understood through the lens of behavioral paternalism, and there are many possibilities for further regulation along these lines. Some of the more

promising possibilities not taken up by regulators so far include the default mortgage deal and customized cooling-off devices for credit cards.

It is, however, important to bear in mind the potential weaknesses of behavioral paternalism. Even light forms of paternalism may be costlier in practice than they seem on paper, because there are many hidden costs that are likely to be ignored. The case for paternalistic policies should also be empirically verified, not merely posited on the basis of vague theoretical notions. Finally, it is important to examine the prospects of market-based solutions for helping consumers choose better, because these solutions are likely to be more flexible and innovative than solution imposed by law.

REFERENCES

Agarwal, Sumit, Souphala Chomsisengphet, Chunlin Liu and Nicholas S. Souleles (2006), Do Consumers Choose the Right Credit Contracts?, Federal Reserve Bank of Chicago WP 2006-11, November 2006, http://ssrn.com/abstract=943524.

Ausubel, Lawrence M. (1991), The Failure of Competition in the Credit Card Market, *American Economic Review*, 81, 50-81.

Bar-Gill, Oren (2004), Seduction by Plastic, *Northwestern University Law Review* 98, 1373-1434.

Bar-Gill, Oren and Elizabeth Warren (2008), Making Credit Safer, *University of Pennsylvania Law Review* 157, 1-101.

Barr, Michael S., Sendhil Mullainathan and Eldar Shafir (2008), Behaviorally Informed Financial Services Regulation, New America Foundation, October 2008.

Becker, Gary (1992), Habits, Addictions, and Traditions, *Kyklos*, 45, 327–346.

Becker, Gary and Kevin Murphy (1988), A Theory of Rational Addiction, *Journal of Political Economy*, 96, 675–700.

Brown, Tom and Lacey Plache (2006), Paying with Plastic: Maybe Not So Crazy, *University of Chicago Law Review*, 73, 63-86.

Camerer, Colin, Samuel Issacharoff, George Loewenstein, Ted O'Donoghue and Matthew Rabin (2003), Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism", *University of Pennsylvania Law Review*, 151(3), 1211–1254.

Campbell, John Y. (2006), Household Finance, *Journal of Finance*, 61(4), 1553-1604.

DiMatteo, Larry A. (1997), The Counterpoise of Contracts: The Reasonable Person Standard and the Subjectivity of Judgment, *South Carolina Law Review*, 48, 343-356.

Dowd, Kevin and Martin Hutchinson (2010), *Alchemists of Loss: How Modern Finance and Government Intervention Crashed the Financial System*, Chichester, UK: Wiley.

Dworkin, Gerald (2010), Paternalism, in Edward N. Zalta (ed.), *The Stanford Encyclopedia of Philosophy (Summer 2010 Edition)*, available online at http://plato.stanford.edu/archives/sum2010/entries/paternalism (6.6.2011).

Elliehausen, Gregory (2010), Implications of Behavioral Research for the Use and Regulation of Consumer Credit Products, FEDS Working Paper No. 25, http://ssrn.com/abstract=1783770.

Entitle Direct (2010), *The Smart Consumer's Guide to the New Good Faith Estimate*, http://www.entitledirect.com/static/entitle/The%20Smart%20Consumers%20Guide%20to%20the%20New%20Good%20Faith%20Estimate.pdf.

Epstein, Richard A. (2006), Behavioral Economics: Human Errors and Market Corrections, *University of Chicago Law Review*, 73(1), 111-132.

European Commission (2011a), *Creating a fair single market for mortgage credit – FAQ*, MEMO/11/205, 31 March, Brussels.

European Commission (2011b), *Proposal for a Directive of the European Parliament and of the Council on Credit Agreements Relating to Residential Property*, COM(2011) 142 final, Brussels, 31.3.2011.

European Commission (2011c), *Impact Assessment, Accompanying document to the Proposal for a Directive of the European Parliament and of the Council on Credit Agreements Relating to Residential Property*, SEC(2011) 356, Brussels, 31.3.2011.

Finnish Consumer Agency (2009), *Finland proposes better protection than the new Consumption Credit Directive to protect the consumer*, 7.12.2009, available at http://www.kuluttajavirasto.fi.

Ginsburg, Douglas H. and Joshua D. Wright (2012), Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty, *Northwestern University Law Review*, 106(3), (forthcoming).

Glaeser, Edward L. (2006), Paternalism and Psychology, *University of Chicago Law Review*, 73, 133-156.

Gneezy, Uri and John A. List (2006), Putting Behavioral Economics to Work: Testing for Gift Exchange in Labor Markets Using Field Experiments, *Econometrica*, 74(5), 1365–84.

Gorton, Gary B. (2010), *Slapped by the Invisible Hand: The Panic of 2007*, Oxford University Press.

Haupt, Stefan (2003), An Economic Analysis of Consumer Protection in Contract Law, *German Law Review*, 4(11), 1137–1164.

Hayek, Friedrich A. (1945), The Use of Knowledge in Society, *American Economic Review*, 35(4), 519-30.

Hill, Claire A. (2007), Anti-Anti-Anti-Paternalism, *NYU Journal of Law & Liberty*, 2, 444-454.

Jakobsson, Niko (2008), Pikaluotot – hämärää markkinointia, kohtuuttomia sopimusehtoja ja koronkiskontaa? (Instant Loans – Unclear Marketing, Unreasonable Terms and Usury?), *Helsinki Law Review*, 145-173.

Jolls, Christine, and Cass R. Sunstein (2006), Debiasing through Law, *Journal of Legal Studies* 35, 199–241.

Kaartinen, Risto and Jaana Lähteenmaa (2006), *Miten ja mihin nuoret käyttävät pikavippejä ja muita kulutusluottoja?*, Kauppa- ja teollisuusministeriö (Finnish Ministry of Trade and Industry), Rahoitetut tutkimukset 10/2006.

Kahneman, Daniel, Jack L. Knetsch and Richard H. Thaler (1990), Experimental Tests of the Endowment Effect and the Coase Theorem, *Journal of Political Economy*, 98, 1325-1348.

Kaplow, Louis (2000), General Characteristics of Rules, in Boudewijn Bouckaert and Gerrit De Geest (eds), *Encyclopedia of Law and Economics, Vol. V: Economics of Crime and Litigation*, Cheltenham: Edward Elgar, 502–528.

Kelman, Mark, Yuval Rottenstreich and Amos Tversky (1996), Context-Dependence in Legal Decision Making, *Journal of Legal Studies*, 25, 287.

Kirzner, Israel M. (1973), *Competition and Entrepreneurship*, Chicago: University of Chicago Press.

Kirzner, Israel M. (1997), *How Markets Work: Disequilibrium, Entrepreneurship and Discovery*, London, UK: Institute of Economic Affairs.

Klick, Jonathan and Gregory Mitchell (2006), Government Regulation of Irrationality: Moral and Cognitive Hazards, *Minnesota Law Review*, 90, 1620-1663.

Korobkin, Russell (1998a), The Status Quo Bias and Contract Default Rules, *Cornell Law Review*, 83, 608.

Korobkin, Russell (1998b), Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms, *Vanderbilt Law Review*, 51, 1583.

Korobkin, Russell (2000), Behavioral Economics, Contract Formation, and Contract Law, in Cass R. Sunstein (ed.), *Behavioral Law and Economics*, Cambridge University Press, new York, 116–143.

Lacko, James M. and Janice K. Pappalardo (2007), *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms*, Staff Report, Federal Trade Commission, Washington DC.

Langevoort, Donald C. (1995), Ego, Human Behavior, and Law, *Virginia Law Review* 81, 853.

La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert W. Vishny (1998), Law and Finance, *Journal of Political Economy* 106, 1113–1155.

List, John A. (2003), Does Market Experience Eliminate Anomalies?, *Quarterly Journal of Economics*, 118(1), 41-71.

Loewenstein, George and Ted O'Donoghue (2006), "We Can Do This the Easy Way or the Hard Way": Negative Emotions, Self-Regulation, and the Law, *University of Chicago Law Review*, 73, 183-206.

London Economics (2009), *Study on the Costs and Benefits of the Different Policy Options for Mortgage Credit*, Final report to the European Commission, Internal Market and Services DG, prepared by London Economics and Achim Dübel (Finpolconsult) in association with institut für finanzdienstleistungen e.V. (iff), November 2009.

Määttä, Kalle (2010), Pikaluottojen sääntely oikeustaloustieteellisestä näkökulmasta, *Lakimies* 2010/3, 265-279.

Mann, Ronald (2007), Bankruptcy Reform and the "Sweat Box" of Credit Card Debt, *Illinois Law Review*, 2007(1), 375-403.

Masciandaro, Donato (2001), In Offense of Usury Laws: Microfoundations of Illegal Credit Contracts, *European Journal of Law and Economics*, 12, 193–215.

Miles, David (2003), *The UK Mortgage Market: Taking a Longer-Term View. Interim Report: Information, Incentives, and Pricing*, HM Treasury, London.

Miles, David (2004), *The UK Mortgage Market: Taking a Longer-Term View. Final Report and Recommendations*, HM Treasury, London.

Milevsky, Moshe A. (2001), Mortgage Financing: Floating Your Way to Prosperity, Research Report #01-01, IFID Centre, University of Toronto.

Milevsky, Moshe A. (2004), Mortgage Financing: Should Your Still Float? Four Answers, IFID Centre, University of Toronto.

Mitchell, Gregory (2002), Taking Behavioralism Too Seriously? The Unwarranted Pessimism of the New Behavioral Analysis of Law, *William and Mary Law Review*, 43, 1907-2021.

Mitchell, Gregory (2003), Why Law and Economics' Perfect Rationality Should Not Be Traded for Behavioral Law and Economics' Equal Incompetence, *Georgetown Law Journal*, 91, 67.

Mitchell, Gregory, (2005), Libertarian Paternalism Is an Oxymoron, *Northwestern University Law Review*, 99, 1245-1277.

Morris, Robin A. (1988), Consumer Debt and Usury: A New Rationale For Usury, *Pepperdine Law Review*, 15, 151-179.

Optem (2009), *Consumer Testing of Possible New Format and Content for the ESIS on Home Loans*, Final Report, European Commission, Directorate-General for Internal Market and Services, October 2009.

Plunkett, Leah A. and Ana Lucía Hurtado (2011), Small-Dollar Loans, Big Problems: How States Protect Consumers from Abuses and How the Federal Government Can Help, *Suffolk University Law Review*, 44, 31-88.

Posner, Richard A. (1998), Rational Choice, Behavioral Economics, and the Law, *Stanford Law Review*, 50(5), 1551-1575.

Prelec, Drazen and Duncan Simister (2001), Always Leave Home Without It: A Further Investigation of the Credit-Card Effect on Willingness to Pay, *Marketing Letters* 12, 5-12.

Rabin, Matthew (1998), Psychology and Economics, *Journal of Economic Literature* 36, 11-46.

Rachlinski, Jeffrey J. (1998), A Positive Psychological Theory of Judging in Hindsight, *University of Chicago Law Review*, 65, 571-625.

Rachlinski, Jeffrey J. (2003), The Uncertain Psychological Case for Paternalism, *Northwestern University Law Review*, 97, 1167-1225.

Rachlinski, Jeffrey J. (2006), Cognitive Errors, Individual Differences, and Paternalism, *University of Chicago Law Review*, 73, 207-229.

Renert, Ian L. (1995), Government study concludes 50%-60% of all adjustable rate mortgages contain errors, *National Public Accountant*, December 1.

Rougeau, Vincent D. (1996), Rediscovering Usury: An Argument for Legal Controls on Credit Card Interest Rates, *University of Colorado Law Review*, 67(1), 1-46.

Shiller, Robert J. (2004), *The New Financial Order: Risk in the 21st Century*, Princeton University Press.

Shu, Susanne B. (2007), *Choosing for the Long Run: Making Trade-offs in Multiperiod Borrowing*, Working paper, UCLA.

Simon, Herbert A. (1947), *Administrative Behavior: A Study of Decision-Making Processes in Administrative Organizations*, New York: MacMillan.

Skog, Ole-Jørgen (2005), Addiction, Choice, and Irrationality, in Francesco Parisi and Vernon L. Smith (eds), *The Law and Economics of Irrational Behavior*, Stanford, CA: Stanford University Press, 111–140.

Soto, Gloria M. (2009), *Study on the Calculation of the Annual Percentage Rate of Charge for Consumer Credit Agreements*, European Commission, Directorate-General Health and Consumer Protection.

Suber, Peter (1999), Paternalism, in Christopher Berry Gray (ed.), *Philosophy of Law: An Encyclopedia*, vol. II, pp. 632–635, New York: Garland Publishing, available at http://www.earlham.edu/~peters/writing/paternal.htm (6.6.2011).

Sunstein, Cass R. (1997), Behavioral Analysis of Law, *University of Chicago Law Review*, 64, 1175.

Sunstein, Cass R. (2006), Boundedly Rational Borrowing, *University of Chicago Law Review*, 73, 249-270.

Sunstein, Cass R. and Richard H. Thaler (2003), Libertarian Paternalism Is Not an Oxymoron, *University of Chicago Law Review*, 70(4), 1159–1202.

Taylor, John B. (2009), *Getting Off Track: How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis*, Hoover Institution Press.

Thaler, Richard H. and Cass R. Sunstein (2009), *Nudge: Improving Decisions About Health, Wealth and Happiness*, revised edition, Penguin Books.

Turner Review (2009), *The Turner Review: A regulatory response to the global banking crisis*, Financial Services Authority, March 2009, London, http://www.fsa.gov.uk/pubs/other/turner_review.pdf.

Valkama, Elina and Vesa Muttilainen (2008), *Maksuvaikeudet pikaluottomarkkinoilla*, Oikeuspoliittisen tutkimuslaitoksen tutkimustiedonantoja 86, Helsinki.

Willis, Lauren E. (2006), Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price, *Maryland Law Review* 65, 707–840.

Whitman, Douglas Glen and Mario J. Rizzo (2007), Paternalist Slopes, *NUY Journal of Law & Liberty*, 2, 411-443.

Wright, Joshua D. (2007), Behavioral Law and Economics, Paternalism, and Consumer Contracts: An Empirical Perspective, *NUY Journal of Law & Liberty*, 2, 470-511.

Essay 3

Social Norms, Morality, and the Law: Regulatory Strategies[*]

ABSTRACT

The present paper explores two related ways for improving law and regulation. The first is to link laws and regulations with the realm of social norms and other sources of normativity that govern human choosing and acting. The second is to explore the role of intrinsic motivations, moral character and broader culture in human decision-making. These perspectives are translated into regulatory strategies that (i) align laws with positive social norms and motivations, (ii) seek to foster positive norms and cultivate moral habits, and (iii) rely, when appropriate, on moral and social norms for the enforcement of laws.

[*] An earlier version of this paper was presented at the International Conference on Legislative Studies, Helsinki, 1–2 March 2010, and published as "Law, Social Norms and Better Regulation" in Jyrki Tala & Auri Pakarinen (eds.), Better Regulation – A Critical Assessment, National Research Institute of Legal Policy, Research Communications 105, Helsinki, pp. 3–26.

CONTENTS

1 INTRODUCTION 3
2 SOCIAL AND BEHAVIORAL THEORY: TWO PROPOSALS 3
2.1 Against Legal Centralism 3
2.2 Law and Social Norms 4
2.3 Incentives, Motivation and Moral Behavior 8
2.3.1 Intrinsic Motivation 9
2.3.2 Fairness and Moral Emotions 10
2.3.3 Moral Character 11
3 STRATEGIES FOR BETTER LAW MAKING AND REGULATION 12
3.1 Alignment Strategies 12
3.2 Culture-Building and Habit-Formation Strategies 16
3.3 Enforcement Strategies 20
4 CONCLUSION 22
REFERENCES 22

1 INTRODUCTION

The starting point of this paper is twofold. Firstly, *theories of regulation*[1] *imply theories of man and society*: what human persons are; how they choose and behave; how they interact with each other; why and when they obey laws, and so on. Secondly, *there is nothing more useful than a good theory*. A good theory is one that is sufficiently simple, so that it can be used in practice, and sufficiently realistic, so that it does not significantly depart from the truth.[2]

One of the most successful theoretical frameworks in regulatory literature has been law and economics, which combines legal and economic analysis. It is a useful approach, because it is both quite simple and quite realistic. It is not my intention to do away with it, but I will argue that it can and should be improved. There are two improvements that seem especially pertinent.

One is to challenge 'legal centralism' and to adopt a broader understanding of the sources of normativity in human choosing and acting. In other words, we should not limit the analysis to different types of law and their usefulness in regulation. The other is to expand our concept of motivation in human behavior, especially taking into such notions as moral character and culture. In what follows, I will firstly explain these ideas in more detail and then suggest implications for regulatory discussion.

2 SOCIAL AND BEHAVIORAL THEORY: TWO PROPOSALS

2.1 Against Legal Centralism

My first objective is to challenge the legal centralism that is implicit in most law-and-economics and regulatory theory and debate. It is assumed that law is what matters: simply put, when there is a problem, we probably need a new law. This assumption is not often said explicitly, but it is implicit in the logic of most legislative and regulatory projects. Certainly, legislators and regulators are increasingly aware of the *limits of legislation and regulation:* they realize that law cannot do everything. But then again, that is often where the analysis stops.

Yet much more can be said about it – and has been said. The French aristocrat, Alexis de Tocqueville once mused in his observations on the democratic experiment of the United States: 'Laws are always unsteady when unsupported by mores; mores are the only tough and durable power in a nation' (Tocqueville 1969: 274).

---

[1] I am using the word *regulation* in a broad sense that covers both 'regulatory law' properly speaking and other kinds of deliberate state influence, ranging from general legal rules to specific intervention by regulatory bodies. I do however distinguish it from other (non-state) forms of social control or influence. See Baldwin and Cave (1999: chapter 1) for different definitions of the concept of regulation

[2] This is obviously a simplistic summary of very complex set of issues.

More recently, we have seen a burgeoning literature on the roles of and relationships between law, social norms, private morality, culture etc. Contributors to this discussion include several recipients of the Nobel Prize in economics. Ronald Coase (1991), for example, has frequently argued for the importance of studying the economic system empirically, especially in light of the *richness of institutional arrangements*. Drawing on evidence from economic history, Douglass North (1990) has studied the roles of *formal and informal institutions* in economic development. In her empirical work on the governance of common-pool resources, Elinor Ostrom (1990) has demonstrated the complexity and fundamental importance of *non-state governance*. Oliver Williamson (2000) has also underlined the role of non-state governance institutions in the transition from socialism to a market economy.

Among experts of regulation, Ayres and Braithwaite (1992: 12–14) could especially be mentioned for their stress on the role of communities and associations in understanding the institutional order of a society. And in law-and-economics literature, we have seen wide-ranging discussions on the roles and interactions between law and social norms.[3] In the next section I will highlight some interesting findings of this discussion and then draw out implications for regulation.

2.2 Law and Social Norms

The perspective here is not simply that there are limits to legislation. It is that law, social norms, culture, morality and so on are *parts of a complex whole* that should be analyzed as such. The argument for a more holistic perspective is that, firstly, *it is more realistic*, and secondly, *it is possible*. Although 'social norms' is a vague concept, it can be studied both theoretically and empirically.[4] In broad terms, both social norms and law can be seen as sources of normativity for human choosing and acting – sources which may be complementary or conflicting, supportive or eroding.

Social norms and law relate to and interact with each other in various ways (see Panther, 2000). On the one hand, law and social norms may *complement* each other, as is perhaps often the case without our even noticing it. Social norms provide the broad institutional environment within which legal norms and formal institutions function and operate. The central importance of these *supportive social norms* is usually only appreciated when they begin to be eroded. The supportive function may also manifest itself the other way around:

[3] Mercuro and Medema (2006: chapter 7) provide a good overview of the literature.

[4] There is a rich literature connecting social norms and evolutionary game theory: see for example Binmore (2004, 2005), Ostrom (2000) and Young (1998, 2008). North (1990: chapter 5) is a theoretically broader discussion of internal constraints. See also Juurikkala (2009) for a review of the literature on law and social norms in the context of commercial relationships.

enshrining pre-existing social norms into law will give them greater strength and importance – perhaps even if such laws are difficult to enforce.[5]

On the other hand, law may come into *conflict* with social norms. In such setting there are several possible scenarios. (i) It may be that, over time, *social norms adapt to legal rules*. This is likely to happen when such adaptation does not imply a loss on any significant party. But it may also be argued that generally law tends to shape social norms through its 'expressive function' (Sunstein, 1996a, Cooter, 2000).[6] (ii) *Legal rules may adapt to social norms*. In broad terms this happens often through legal reform, given that social norms are among the main factors that influence legal and social change.[7] But it may also happen that 'law in the books' is supplanted by 'law in action' that reflects entrenched social norms in opposition to the literal meaning of the law. (iii) *The two may also influence each other*, one dominating from time to time and in different contexts.

Some social and legal theorists have emphasized the importance of social norms as the proper basis of legal norms.[8] Cooter (1996) argues that English contract law was rooted in the traditional 'law merchant' (*lex mercatoria*), which was based on business customs and cooperative dispute resolution mechanisms. As the power of English common law judges grew, they began to deal with commercial disputes; but instead of trying to create a new set of rules, they sought to discover the rules already in existence among merchants, and to enforce those rules selectively so as to create a coherent and systematic body of rules.

However, placing too much emphasis on law may have an *adverse effect on social norms*. Pildes (1996) has warned about the possibility of destroying valuable social norms through law. In the same vein, Ostrom (2000: 147) writes:

> 'Several [...] recent experimental studies have confirmed the notion that external rules and monitoring can crowd out cooperative behavior. [...] Moreover, norms seem to have a certain staying power in encouraging a growth of the desire for cooperative behavior over time, while cooperation enforced by externally imposed rules can disappear very quickly.'

---

[5] Cooter (2000) gives an amusing example. A new law in California required dog-walkers to clean up the poop. Before that, most people thought that was the right thing to do anyway, yet people did not complain much about dog poop; now after the new law, they do complain if someone breaks the law. It is easier to say 'obey the law' than 'don't be so rude'. When a standard of behavior is included in the legal code, it has the moral backing of the legitimate public authorities of the community.

[6] For example, laws relating to environmental protection, tobacco smoking or drug use can have a powerful effect on public perceptions and expectations.

[7] An interesting historical example, among many others, is the formation of the Western legal concepts of criminal culpability, which emphasizes subjective intention instead to the objectivism of earlier Germanic practice; this notion of culpability was simply rooted in Christian moral theology (Berman, 1983).

[8] Earlier contributions include Hayek (1960, 1973) and Leoni (1991).

Various fundamental social virtues, such as reciprocity, are learnt and acquired not through law but through life in smaller communities such as families, clubs and churches (see Tocqueville, 1969). Such social norms as reciprocity can be undermined through law-making and public policy by destroying the social conditions that enable informal reciprocity. For example, urban planning, when it pays little attention to the social context, may remove the practical opportunities for exercising reciprocity and maintaining active community life; thus the transition from busy street interaction to empty and quiet places may, paradoxically, have lead to the creation of more dangerous neighborhoods (see Jacobs, 1961). Similarly, overambitious welfare policies may crowd out pre-existing local-level and voluntary institutions that provide informal but effective remedies in unemployment, illness and old age (Beito, 2000, Putnam, 2000, Juurikkala, 2007).[9] It may therefore be that sometimes law should simply provide a good, broad institutional context, but avoid unwise *over-judicialization* of society, as that may have complex and negative long-term consequences. As Ostrom (2000: 147–148) warns:

> 'the worst of all worlds may be one where external authorities impose rules but are only able to achieve weak monitoring and sanctioning. In a world of strong external monitoring and sanctioning, cooperation is enforced without any need for internal norms to develop. In a world of no external rules or monitoring, norms can evolve to support cooperation. But in an in-between case, the mild degree of external monitoring discourages the formation of social norms, while also making it attractive for some players to deceive and defect and take the relatively low risk of being caught.'

One of the central insights of the social-norms perspective is that both law and social norms have their proper role and scope. Even when they support each other, they operate very differently. For example, Bernstein (1996) observes that there are many reasons why parties to a commercial transaction may actually prefer some aspects of their agreements and relationships to be *legally unenforceable*. Negotiating remote contingencies may signal distrust or unusual desire to litigate, and overly detailed contracts may make things too inflexible if circumstances change; legal system costs (litigation costs, delays, risk of judicial error) are high and both parties may prefer to avoid the possibility of legal battles; and there are many factors that are known to the parties by not verifiable by in a legally enforceable way. One common strategy seems to be that

[9] Beito (2000) is an insightful historical investigation of how so-called fraternal societies in the late nineteenth and early twentieth century provided extensive assistance ranging from health insurance, support in unemployment, orphanages, and homes for the elderly. Similar institutions existed in many European countries. Beito argues that such institutions died out not because they were deficient but because governments took over their role with taxpayer money, yet something important was lost in the transition.

commercial transactors govern their dealings through flexible, cooperative social norms when they have a mutually beneficial, long-term relationship; but they combine those norms with legally stricter contracts that can be invoked if the other party turns out to be untrustworthy.

This sensitivity to social context is reflected in some traditional legal principles such as the English doctrine that, when it comes to agreements of a domestic nature, there is a rebuttable presumption that the parties did not intend to create legal relations. The wisdom of this principle is that legal battles tend to shatter relationships, and strictly legal rights and duties cannot contain the rich and complex notions of justice and reasonableness that parties to a personal and long-term relationship have. As Lord Justice Atkin famously put it:

> 'The common law does not regulate the form of agreements between spouses. Their promises are not sealed with seals and sealing wax. The consideration that really obtains for them is that natural love and affection which counts for so little in these cold Courts. The terms may be repudiated, varied or renewed as performance proceeds or as disagreements develop, and the principles of the common law as to exoneration and discharge and accord and satisfaction are such as find no place in the domestic code.'[10]

Greater sensitivity to the relationship between law and social norms also enables us better to understand legal – and regulatory – practices in *different cultures and societies*. Each culture is a product of numerous factors working over centuries and millennia. Western legal culture cannot be properly understood without taking into account the complex 'synthesis of Athens, Jerusalem, and Rome' (Gregg, 2003: xiv) that gave rise to Western civilization. In such places as Africa, India or China, the history and the accompanying social norms are very different indeed. Winn (1994), for example, argues that in the context of non-Western countries like China, it is appropriate to speak of *legal marginalism*, because Chinese relational systems give more importance to elaborate notions of reciprocity and trustworthiness.

Last but not least, social norms can be enforced through various *non-legal sanctions*, which in some respects resemble legal sanctions but in other respects are quite different (Panther, 2000, Charny, 1990). On the one hand there are *external sanctions* of two types, (i) *second-party control* and (ii) *third-party control*. Second-party control refers to non-legal sanctions that may be used by the other party to the transaction, such as refusing to do business again or creating credible threats (Williamson, 1983). Third-party control requires the cooperation of third parties, for example in the form of gossiping, shaming, and loss of reputation. Then there is also a third type of non-legal sanction, namely (iii) *internal sanctions* (which may also be called *first-party sanctions*). They are various

---

[10] *Balfour v Balfour* [1919] 2 KB 571, at 579–580.

emotional reactions that human beings may have as a result of following or breaking social norms. On the positive side, they include such emotions as empathy, human desire for approval, honor and esteem. On the negative side, one may experience regret, remorse, shame, guilt and embarrassment. Frank (1987, 1988) proposes that the ability to undergo such emotional reactions is valuable, because it supports the establishment of mutually beneficial, cooperative relationships.

The idea here is not simply that social norms can be enforced too, but that legal and non-legal sanctions are different yet related to each other. For example, Cooter (2000) notes that, although legal enforcement of rights and duties is often necessary, it also tends to be expensive, time-consuming and uncertain. Therefore it is important that laws be complemented by social norms which support reasonable behavior. On the other hand, Pildes (1996) argues that over-intrusive laws can destroy social capital by failing to see the differences between enforcing social norms and enforcing laws. Social norms are not substantive rules, but they are *dynamic wholes* which are tied to complex social structures and flexible enforcement mechanisms. The informal enforcement of social norms differs drastically from formal legal processes, and the remedies available for breach of social norms are flexible and subtle, something that is rarely the case with law. This is a reason to respect the proper realm of social norms.

2.3 Incentives, Motivation and Moral Behavior

I have tried to show that the legal centralism of much of regulatory debate is neither necessary nor fruitful, because better results can be obtained by looking at a broader scope of sources of normativity. My second objective is to show that we can and should do the same about our understanding of human motivation and morality. The motivational and ethical perspective on behavior goes beyond informal social constraints. Mitchell (1999: 208–209), for example, has powerfully criticized the new 'norms jurisprudence' for accepting too much of the behavioral and positivistic attitude of modern social science and economics; the approach may end up distorting instead of improving the explanation of norms, because the leading authors

> 'generally share the same basic goal, which is to establish a non-normative theory of norms. [...] They tend to share an underlying metanorm of efficient wealth or welfare maximization, and all share the basic belief that people are motivated principally – if not solely – by self-interest. Most importantly, by limiting their inquiry to what they see, they are unable to explain, except at the most superficial level, how norms become normative – that is, how they come to tell us what we ought (or ought not) to do.'

The economic and political importance of *internal moral norms* has acknowledged by many authors, including Douglass North (1990). He writes, among other things, that

> 'One gets *efficient* institutions by a polity that has built-in incentives to create and enforce efficient property rights. But it is hard – maybe impossible – to model such a polity with wealth-maximizing actors unconstrained by other considerations. It is no accident that economic models of the polity developed in the public choice literature make the state into something like the Mafia [...]. Now we do not have to look far afield to observe states with such characteristics. But the traditional public choice literature is clearly not the whole story.' (North, 1990: 140)

The political scientist William Riker (1976) has likewise argued that it is implausible to claim that the emergence of stable and economically efficient political structures can be explained merely by the establishment of a good constitution. Discussing the role of constitutional forms in restraining the tyrannical exercise of political power, he writes:

> 'The question is: Does constitutional structure cause a political condition and a state of public opinion or does the political condition and a state of public opinion cause the constitutional structure? The sounds at first like the chicken and egg problem in which there is no causal direction; but I think that usually there is a cause and that constitutional forms are typically derivative. It seems probably to me that public opinion usually causes constitutional structure, and seldom, if ever, the other way around. As Rousseau contended, it is in the end the law that is written in the hearts of the people that counts.' (Riker, 1976: 13)

The theoretical literature related to internal moral norms is so vast that it is not possible to discuss it exhaustively here. The following sections highlight some perspectives that seem to have strong empirical backing and that also lend support to each other.

2.3.1 Intrinsic Motivation

It is obvious that people do many things not because they get some external benefit from it but because is an immediate source of human fulfillment (see Staw, 1976, Deci and Flaste, 1995, Frey, 1997). Children need not be paid to play, and even few adults work only for the money (this is especially true of some professions, notably academic research). Similarly, most people devote time and energy to different forms of friendship and community – especially marriage and the family – not only because of some external benefits but mainly because friendship itself is an important aspect of truly human life.

Nevertheless, mainstream economic models of human behavior tend to ignore the relevance of intrinsic reasons for action, because they treat human motivation as a 'black box'. The problem is that this leads to too much importance being given to external compensation or punishment. Many empirical studies have shown that external incentives – sticks and carrots – do not always produce the desired results, because external interventions interact with intrinsic motivations in complex ways (Frey 1993, Kohn, 1993). Building on a wealth of psychological literature, Frey (1997) summarizes the relationships between intrinsic and extrinsic motivation as follows:

(i) Intrinsic motivation is of great importance for all human activities; it is inconceivable that people are motivated solely or even mainly by external incentives.

(ii) The use of monetary incentives crowds out intrinsic motivation under identifiable and relevant conditions (*Crowding-Out Effect*). The same may also be true of other external interventions such as commands or regulations.

(iii) External interventions may, on the other hand, enhance intrinsic motivation under some conditions (*Crowding-In Effect*).

(iv) Changes in intrinsic motivation may spill over to areas not directly affected by monetary incentives or regulations (*Spill-Over Effect*).

For example, when a child is paid for doing household chores, she is unlikely to contribute without compensation (crowding-out effect). Yet if her father gives her a surprise present as she has been helpful in the house, it is likely to reinforce her intrinsic willingness to help out (crowding-in effect). As a general rule, when external intervention is perceived as *controlling* or *failing to recognize* the intrinsic value of a non-instrumental relationship, it crowds out intrinsic motivation. On the other hand, when it is perceived as *supportive*, self-esteem is fostered and people feel they are encouraged to act with self-determination.

These considerations have great relevance for law and regulation. The same as with social norms, legal constraints and interventions may negatively influence the intrinsic motivations of individuals to cooperate, be honest and generous with each other, and so on. David Hume famously advised that a country's constitution should be designed for 'knaves' motivated solely by their 'private interest' (Hume, 1898: 117–118). But the evidence on intrinsic motivation suggests that the opposite may be the case: such a constitution may end up produces knaves when they did not exist before, at least not in large numbers (Bowles, 2008; Frey, 1997: chapter 6). Legal policies that signal distrust of citizens may be counterproductive from the viewpoint of morality.

2.3.2 Fairness and Moral Emotions

The theory of intrinsic motivation shows that rational self-interest cannot be reduced to external interests and benefits. Evidence on altruistic behavior goes further away from the narrow concept of rationality found in mainstream

economic models: ordinary people often act in other-regarding ways even at the a substantial cost to themselves (see Frank, 1988). However, fairness-based behavior is usually complex and dynamic. According to Rabin (1993), the empirical evidence can be summarized in three simple principles:

(a) People are willing to sacrifice their own material well-being especially *to help those who are being kind*.[11]

(b) People are willing to sacrifice their own material well-being *to punish those who are being unkind*.

(c) Both motivation (a) and (b) have a greater effect on behavior as the material cost of sacrificing becomes smaller.

In other words, most people care about fairness in two ways. On the one hand, they want to treat others fairly, treating them well especially when they have received good treatment. On the other hand, people tend to retaliate against those who have treated them badly. But importantly, the extent of fairness-based behavior nevertheless varies according to various criteria, such as reputation effects, amount of material loss, standards of fairness, and self-image.

2.3.3 Moral Character

Yet moral behavior is not a question of emotions alone. Already the ancient Greeks thought that human persons can become morally better or worse, according to their education and their own free choices. Aristotle's *Nicomachean Ethics* (1980) is a systematic exposition of such *virtue ethics,* which sees good moral character as the result of good habits, i.e. internal capabilities of acting justly, wisely, honestly, maturely etc. Through a consistent attempt to use one's reason, to give each person their due, to overcome internal inertia, and to channel one's various desires according to reason, one develops the cardinal virtues of prudence, justice, fortitude and temperance – habits which in turn make it easier for that person to do the right thing in concrete situations.[12] There is also a rich literature of the moral psychology view of virtues that takes into account more recent work in psychology.[13]

It cannot be denied that the moral character of persons and citizens is fundamental for the well-being of communities and nations. If all men and women are just and reasonable, law has merely a marginal and supportive role to play. Yet if everyone is cruel, selfish, dishonest and irrational, there is no legal and regulatory solution in the world to deal with all the resulting social problems. Indeed, it can be argued that the optimal extent and manner of law

[11] This is not to deny that people can act altruistically regardless of how the others behave; one thinks of all kinds of voluntary workers. However, that probably requires stronger internal commitment to help others, and also the positive response of those being helped is likely to reinforce one's willingness to make sacrifices for them.

[12] For a modern exposition of virtue ethics, see Pieper (1966).

[13] See Peterson and Seligman (2004) and the numerous references cited therein.

and regulation greatly depends on the moral character of the relevant people (see George, 1993).

Recently some economists have come to appreciate the importance of internal moral dispositions and constraints for economic efficiency (see Buchanan, 1994; Fukuyama, 1995; Stringham, 2011; Wight, 2005). It has also been demonstrated empirically – contrary to the conviction of Stigler and Becker (1977: 76) that 'deplorable tastes [...] are not capable of being changed by persuasion' – that moral dispositions are not beyond external influence. For example, Ariely (2008: 207–209) reports that starting experiments by asking subjects to think about the Ten Commandments made them more likely to tell the truth, probably because the exercise reinforced moral commitments that the subjects already had in their background. In another series of experiments by Dal Bó and Dal Bó (2010), experimental subjects were exposed to a variety of messages, some of which contained a moral argument; this kind of moral suasion had a significant effect on behavior. Interestingly, cooperative behavior was particularly common when the moral message was combined with the presence of punishments – more common than with either of them alone.

3 STRATEGIES FOR BETTER LAW MAKING AND REGULATION

In this section I outline some implications of these perspectives for better legislation and regulation. They have been divided into three categories. First, there are *alignment strategies,* i.e. regulatory approaches that seek to align law and regulation with supportive social norms and intrinsic motivations. The second category is entitled *culture-building and habit-formation strategies,* which focus on influencing social norms for the better and helping persons to adopt good habits. Thirdly, *enforcement strategies* seek to replace or combine legal and formal enforcement with informal enforcement through internal constraints and other non-legal sanctions.

3.1 Alignment Strategies

There are various possibilities for aligning laws and regulations with positive social norms and intrinsic motivations. Here are some general guidelines and examples.

Align regulation with positive social norms. Broadly speaking, positive social norms are those that are constructive, cooperative, pro-social etc. When such norms are strong in the relevant regulatory context, the most effective strategy is likely to one that builds upon and reinforces those norms. Generally, it is likely that in such situations there is no need for heavy, top-down regulation, because a *light-touch, grass-roots approach* will be sufficient, less costly and more effective. This is one reason why some form of self-regulation may be advisable (see

generally Ogus, 2000). This is not to say that self-regulation is the right solution to all situations, for reasons discussed later in more detail. The point is that when there are positive, pre-existing social norms, giving them a semi-formal regulatory status through self- or co-regulatory schemes is likely to *reinforce* those norms – and to suppress less positive social norms and attitudes.

Avoid law and regulation that corrodes valuable social norms. An interesting example in this respect is the effect of intellectual property rights (IPR) on social norms in research communities (see Menell, 2000: 144). Although it is generally agreed that some form of intervention may be necessary to provide incentives for research and development, it has been argued that IPR may undermine progress in science by promoting values that conflict with the traditional norms of collaboration, disinterestedness and the emphasis on path-breaking basic discoveries (Merton, 1973). The adverse effect of IPR may be especially strong in biomedical research, which traditionally has favored the sharing of research to promote progress and serve humanity (Eisenberg, 1987). There is no simple solution to this dilemma, but such proposals as compulsory licensing may be worth consideration – not only for economic efficiency, but also to foster a cooperative culture of research.

It is also interesting to note that in countries such as the UK, law reform proposals have began to give significant weight to surveys on public opinion, which closely relates to social norms.[14] In light of the present paper this is a step forward, because more precise knowledge of public attitudes is vital to the design of good rules. It is however important to understand that public opinion should not be seen as an automatic source of legal normativity, because public attitudes may be poorly founded or incoherent, and social norms may also be manifestly negative and harmful, as is discussed shortly in more detail.

Support positive intrinsic motivation; avoid creating a 'culture of minimal compliance'. The theory of intrinsic motivation gives additional support to light-touch regulation in certain circumstances. Over-intrusive and formalistic regulatory approaches signal mistrust and confrontational attitudes, which are likely to weaken intrinsic motivation to do what is right. If regulatory subjects feel they are being treated mistrustfully and unfairly, they will also tend to respond with spiteful behavior, even to the point of making the job of regulatory authorities as difficult as possible just to 'get even' (see Bardach and Kagan, 1982). In the worse case, the regulators will in response feel their authority being undermined, and will retaliate with even worse treatment, giving rise to a spiral of hostility.

Frey (1997) advises that positive intrinsic motivation is reinforced by external intervention that is perceived as supportive. This perception can be fostered numerous ways. One way is to develop *personal relationships* between regulators and regulatees. Another is to give the regulatees a sense of autonomy and to

[14] See for example Law Commission (2006: 1.21, 5.74-77, 5.84, 7.12-17, 7.47).

provide *participation opportunities*; self- and co-regulation are clear instances of such participation, but one can think of many other possibilities too. Thirdly, the message implied by external intervention is important; for example, *rewards* may be more fruitful in some contexts than punishments and commands.

It will also be better at times to rely on *soft, non-enforceable directives* implemented by agreement instead of hard rules backed up by harsh sanctions. Building on evidence from health and safety regulation, Bardach and Kagan (1982) argue that hard regulation tends to cause crowding-out of intrinsic motivation among the better manager, who otherwise would have gone beyond the regulations. A similar argument could probably be made about environmental regulation, where too much emphasis on prices and regulations may actually have an adverse effect on intrinsic motivations to be pro-environment; the consequences will be even worse if hard regulations are poorly designed.

It is obvious that tough sanctions are sometimes needed. However, Ayres and Braithwaite (1992) argue that regulation should always start with a persuasive approach, and it should provide differentiated treatment for the 'good guys' (those who comply voluntarily) and the 'bad guys' (those prone to cheating). Punishing misbehavior is also important for the intrinsic motivation of others, because they will otherwise feel that the rules are unfair and there is a 'law of the jungle' in place.

Use broad, flexible standards instead of detailed rules. In alignment strategies, flexible and principles-based standards are likely to work better than narrow, detailed rules. The reason is simple: broad standards are similar in kind to social norms – and indeed moral principles – because they focus more on fairness and reasonableness than on formal rights and duties. They are also more flexible and adaptive, which is why many authors claim that they are the best approach in rapidly changing environments. For example, UK industrial safety legislation has been criticized for failing to create any substantial reduction in accidents, partly because the laws center too heavily on machinery accidents that are less relevant in today's workplaces, and also because the mandated safety devices fail to take into account broader factors such as the adaptive responses of workers (Veljanovski, 2007).

Once again, the optimal strategy will depend on the details of each case. Strict rules – or at least demanding interpretation of broad standards – may be necessary when there are *strong adverse incentives* to depart from cooperative and pro-social behavior.

Identify the proper role, scope and style of law and regulation. The theory of social norms highlights the difference between social and legal norms: they operate differently, and this means that it is important to give each a suitable role. In legal and regulatory design, one implication is that we should be conscious and discerning of the relevant social context. In some situations, legal categories and principles cannot adequately reflect the relevant factors that the participants

themselves feel should determine the outcome of certain conduct or dispute. Family problems are the most obvious case, but the issue is relevant to all the examples discussed so far.

It is also important to be conscious of and sensitive to *cultural differences*. They are, for example, a fundamental factor when it comes to the success of 'legal transplants' (see generally Watson, 1993). North (1990: 101) illustrates the problem as follows:

> 'The U.S. Constitution was adopted (with modifications) by many Latin American countries in the nineteenth century, and many of the property rights laws of successful Western countries have been adopted by Third World countries. The results, however, are not similar to those in either the United States or other successful Western countries. Although the rules are the same, the enforcement mechanisms, the way enforcement occurs, the norms of behavior, and the subjective models of the actors are not.'

Boettke (1998) argues likewise that one cannot understand differences of economic development without taking into account the role of culture. The twist in Boettke's argument is that on the general level, we know what kinds of institutions are necessary for economic development – institutions such as private property, sound money, and freedom of contract – but we do not know how to implement them successfully:

> 'Economics may establish the properties of alternative rules, but culture and the imprint of history determine which rules can *stick* in certain environments. The problem is not one of private property and freedom of contract generating perverse consequences, but the fact that some social conventions and customary practices simply do not legitimate these institutions. If market transactions – which are universal – are constrained to a *sub rosa* existence, the commercial life and development will be limited. To move from that *sub rosa* existence, legal-political institutions must be adopted, but such adoption is only possible if there is a cultural fit.' (Boettke, 1998: 13)

A topical example of the role of cultural differences is intellectual property rights (IPR) protection in China. The central government seems to be making an effort to enforce Western-style patents and copyrights, but practices in regional courts and other public bodies can be very different, because Chinese attitudes towards Western rights and privileges are influenced by many factors other than formal legal provisions alone (see Fung, 1996, and Allison and Lin, 1999). The role of culture is also relevant closer to home: the European Union consists of countries with very different histories and cultures, which is one reason why 'one-size-fits-all' solutions may become 'one-size-fits-none' regulations. Thus the

social norms perspective cautions us against excessive centralization of regulation in a setting of large cultural differences.

3.2 Culture-Building and Habit-Formation Strategies

Foster cooperation by combining fairness with toughness. Most of the time social problems are caused by various kinds of destructive, anti-social and uncooperative habits and norms. Can anything be done to improve the situation? One way of looking at it is that, assuming the issue is important and persuasive regulation does not deliver results, tough sanctions are needed. The general idea here is that when people are not freely willing to act fairly and reasonably, external intervention of some type may be needed. An interesting case to consider is the UK Financial Services Authority (FSA), which has been criticized for having adopted an unduly light-touch approach to financial regulation. The criticism has been raised after serious failings and abuses in the UK financial sector, and it is based on the idea that financial market participants are often tempted by powerful monetary incentives to act less-than-completely altruistically.

But the issue is complex: not all finance professionals are selfish and greedy. How should regulation be framed in contexts that include multiple actors with different kinds of motivations and values? Ayres and Braithwaite (1992) propose an interesting strategy, called the *'benign big gun' approach*. The idea is to create a regulatory system that combines persuasion – and thus recognition of positive intrinsic motivation – with severe but targeted sanctions on misbehaving persons. This approach builds on the game-theoretic notion of tit-for-tat strategies, which imply that regulators should normally treat regulatees well, but if their trust is broken, they should respond with punishments, the severity of which is measured in accordance with the seriousness of the offense. Importantly, the success of the benign-big-gun strategy hinges on the ability of regulators to play both reasonable and tough, and also on the credibility of their threat to raise the severity of punishments as the offenses get dirtier. The argument is that, in the optimal case, most actors will perceive the rules as fair and reasonable, because the ordinary approach is flexible and persuasive; and in addition, there will be no incentives to break the rules, because the punishments for violations are sufficiently tough and certain to come.

One might suppose that the benign-big-gun proposal is perfectly obvious and that is how most regulators operate. Unfortunately that is not the case. Ayres and Braithwaite (1992: 49) cite the case of the US Occupational Health and Safety Administration (OSHA), which seems to operate with the completely opposite logic: 'They constantly nip at firms with flea-bite fines. In most encounters with OSHA inspectors, petty punitiveness is in the foreground and no big guns are in the background. The result of flea-biting is that cooperation is destroyed without any of the benefits that can flow from tough enforcement being secured. When scholars point to an agency like OSHA to conclude that

punishment and persuasion are incompatible, they have not understood the foregrounding of cooperation and backgrounding of punishment that benign big guns can accomplish.'

Indeed, there are numerous examples regulations that fail to combine persuasion with serious sanctions. In the context of financial markets regulation, the US Securities and Exchange Commission (SEC) is famed for its tendency to churn out complex and expensive-to-comply regulations that signal a mistrust of anyone participating in financial markets; but when it comes to dirty play involving multi-million dollar pay-offs, the SEC's punitive responses appear more symbolic than real.[15] Perhaps the same could be said about Finnish competition law and its enforcement: even after a recent decision that raises punishment standards in anti-competitive agreement cases, the level of fines is arguably too low (given low probabilities of getting caught) to create a real deterrent effect.[16] In light of the present discussion, such approaches to regulation are likely to fail on both counts: they cultivate both opposition and disobedience.

Use creative strategies to promote positive social norms. The interesting question is whether other – less interventionist and less costly – strategies could be adopted to foster the formation of positive social norms. The ideas cited in this paper suggest that are various ways in which this can be done. Considered in isolation, their impact may be limited, but many of them could be combined to create a holistic solution to a specific social problem.

Frey's (1997) strategies for encouraging intrinsic motivation were already mentioned earlier, but they are equally relevant here: developing personal relationships, giving participation opportunities, providing rewards (instead of, or in addition to, punishments), etc. Now if we are assuming that the initial situation is rather more negative than positive, such light-touch approaches alone may not be enough, but they should never be completely ignored as if some people were beyond any possibility of change. As Goethe famously said, 'Treat a man as he is and he will remain as he is. Treat a man as he can and should be, and he will become as he can and should be.'

In the literature on social norms and law, some commentators have advocated the notion of 'norm entrepreneurship' (Sunstein, 1996b). The idea, common in sociology, is that some individuals have a special role in transforming established social norms through their words and example. The concept can be taken in a value-free sense: 'norm entrepreneurs' may change social norms for better or for worse.

From the viewpoint of regulation, the idea of norm entrepreneurship is highly important. It may of course be difficult for politicians and regulators to change powerful social norms (Posner, 2000). Ordinarily, the only way to change

---

[15] See Partnoy (2003) for a series of case studies.

[16] On the optimal level of fines for antitrust practices, see Wils (2006).

social norms is to violate them in a public and decisive way, and such behavior can be especially risky for public officials, who are so dependent on their acceptance by the public. However, law and regulation may play a role in supporting actions and role models – for example authors, artists and actors – that are committed to challenging harmful social norms. Such support may include, among others, financial and moral support, and protecting such social actors against persecution in the public square. In economic terms, we could say that such legal and regulatory strategies aim to alter the payoffs of potential norm-entrepreneurs. Such strategies obviously call for a high degree of prudence, because they may backfire, and it is difficult to predict all the unintended consequences flowing from attempts to manipulate social norms.

Use creative strategies to cultivate other-regarding behavior. It may also be possible to encourage altruistic behavior in some regulatory settings. As Frank (1987, 1988) has pointed out, personal face-to-face contact tends to advance mutual understanding and altruism (see also Frohlich and Oppenheimer, 1996). This can be illustrated by a counterexample that is familiar to most readers: car-driving. Most drivers become impatient and annoyed much more easily behind the wheel than they would in other situations. According psychologists, the explanation is that conflict situations between different drivers are faceless and non-communicative, which obstructs the development of mutual understanding.

This has at least two implications for regulatory strategy. The first is that when cooperation is needed, the enforcement of laws and regulations should be designed in such a manner that there are sufficient opportunities for personal, face-to-face contact. This strategy can also be used when the challenge is to obtain cooperation in the sense of fairness and honesty; it is simply much more difficult (even for physiological reasons) to lie face-to-face than in an impersonal letter. One can think of many potential areas of application, including the enforcement of tax and competition laws. Note however that in order to promote cooperation and fairness, the rules being enforced must also be seen as fair and reasonable; but the positive side is that personal contact and the exchange of ideas will normally help to create a more affirmative attitude toward the rules too.[17]

The second implication is that laws can be employed to frame the relevant institutional set-ups so as to reduce to need for external intervention. For example, when the aim is to reduce egoistic or greedy conduct by certain individuals, the problem may be alleviated by reducing the amount of impersonal dealings and obliging more personal, face-to-face contact between the relevant transactors. Financial markets and company law are just some potential areas of application.

---

[17] For further discussion in the context of tax policy, see Cowell (1992) and Vihanto (2003).

These examples demonstrate the importance of taking altruistic and fairness-based behavior into account in all legislative and regulatory deliberations. However, altruism cannot always be relied on, and it is necessary to understand the influence of the context. For example, when there are powerful financial or other incentives to cheat or to be selfish, high ideals and internal constraints are more likely to be pushed aside (Rabin, 1993).

Encourage good moral habits and protect the 'moral ecology' of the society. Finally, it is possible to encourage good moral habits. Law has an obvious role of play in this regard in the sense of promoting basic fairness and justice: in the absence of criminal, contract and accident law, many more people would be tempted to opt for unjust modes of conduct. In light of virtue ethics, such conduct would reinforce bad habits in those persons, making them morally worse.

However, virtue in the fullest sense cannot be forced from without; it must involve the free decision of the person to do the good. In this sense, law can play a limited role only. Good moral habits are fostered mainly through one's upbringing, education, role models, example of one's peer group etc. The main responsibility lies therefore in the various institutions of the *civil society*: families, schools, churches, associations and so on.

Nevertheless, the state can make important decisions in this respect too. Just like laws and regulations facilitate the activity of certain 'norm entrepreneurs', similarly they influence the institutional setting in which the civil society operates. Educational laws give direction to the curricula of schools and universities; laws on marriage and the family influence the stability and health of natural families; laws on religious freedom, and even tax laws, influence the ability of religious communities to take formative activities upon themselves; and through its budgetary choices, the state makes numerous decisions that sustain certain social and cultural activities instead of others. Note also that, because of crowding-out problems, even basic social policy choices have complex but powerful consequences on the vitality and social role of various kinds of voluntary associations and charitable organizations (see Beito, 1992).

This perspective of moral habits is not much talked upon today, and it would be easy to dismiss it as secondary, unimportant, or simply too vague. Such skepticism is not warranted. There is a wealth of evidence supporting the view that people are significantly influenced by various educational and social factors, and that good influence can help change them for the better. Perceptions of good life – based on one's upbringing, education, and books and movies – have an empirically measurable effect on moral attitudes.[18] There are also

[18] For example, economics and business education has been criticized for implicitly promoting an egoistic and materialistic ideal of life. Individual cases differ, but empirical studies confirm that economics, finance and business students display more selfishness experiments than other groups: see Frank, Gilovich and Regan (1993, 1996). The effect of economics is not clear, however, as it has been claimed that the selfishness-factor is the result of self-selection rather than indoctrination: Frank and Schulze (2000). Some have sought to challenge the validity of the finding that economists are

encouraging results from certain programs aimed at helping prisoners avoid a criminal career.[19]

In order to cultivate moral virtues, it is also necessary to protect what some have called the *moral ecology* of the society (George, 1993). This broad concept refers to the totality of moral and cultural factors which helps the upright moral development of persons and groups. The protection strategy here can mean many things, including the regulation of advertising so that the natural desire of companies to do more business will not corrupt individuals (young persons in particular) by promoting images and ideals that display materialistic and hedonistic lifestyles, fail to reflect and respect the dignity and rationality of human persons. Similarly, in such fields as entertainment, there is a danger that sales are boosted by way of resorting to the exploitation of human temptation and moral weakness, and public authorities can legitimately act to restrain such influences, especially because the logic of competition may otherwise create pressures for all market participants to engage in dubious practices. Laws might also deliberately aim to protect the public against harmful norm entrepreneurs, i.e. influential individuals that spread norms and values that are destructive of life in society.

Obviously, much prudence is needed.[20] Intrusive intervention in social life risks giving rise to moral paternalism, which may backfire in the longer term. Fundamental values such as freedom of expression are also involved; and taking a moral stand in a pluralistic society provokes the question of conflicting values. Nevertheless, these difficulties alone may not be a sufficient reason to go from one extreme to the other, from paternalism to libertinism. It is generally acknowledged that freedom of expression is not an absolute value, as it needs to be balanced against other human and fundamental rights. Similarly the mere existence of different values is not in and of itself a good reason for taking (whether actively or passively) a particular stand in the debate; and to treat all norms and values as equally laudable is also a position that calls for justification by independent reasons.

3.3 Enforcement Strategies

There are numerous reasons why social norms and internal constraints – either alone or supported by legal enforcement – may provide an attractive basis for

---

more selfish: Laband and Beil (1999) and Yezer, Goldfarb and Poppen (1996). More recent evidence suggests that the selfishness-factor of economics students is selection-based (as it does not increase over the course of the studies), but economics courses taken by non-economics majors seem to have a significant indoctrination effect (making them less generous): Bauman and Rose (2011).

[19] One study finds that Prison Fellowship's *InnerChange Freedom Initiative* participants were 60 percent less likely to be re-incarcerated and 50 percent less likely to be re-arrested than the comparison group (see Johnson, 2003).

[20] See George (1993: 42) for an insightful discussion of the various prudential considerations which might militate in favor of a policy of tolerating certain moral evils.

enforcing socially desirable regulations. They may yield *more effective results*; they may imply *lower costs* for both regulators and regulatees; they may be *more flexible* and also more deeply rooted in *those concerns that matter* (for example, in the case of personal, long-term relationships); and they may *reduce formalistic confrontation*, which tends to corrode cooperative attitudes and positive social norms.

It is not easy to formulate any general principles or guidelines for social-norms-based enforcement strategies, and in any case the enforcement aspect of social norms has been implicit in the foregoing analysis of alignment and culture-building regulatory strategies. Here I would only like to make some additional comments.

One question concerns the conditions that make non-legal enforcement *advisable and effective*. As is clear from the previous sections, this depends on the nature and strength of the relevant social norms and moral values. For example, many aspects of business ethics (such as corporate responsibility programs) are not enforced legally, but there are reputational incentives for implementing effective ethics programs in companies. To some extent, these reputational incentives depend on institutional arrangements and social expectations, which in turn are shaped by various social-norm entrepreneurs. It can be argued that many aspects of corporate responsibility should not be legally enforced, because the complex and aspirational character of business ethics implies that codifying its requirements in legal enforceable codes would be likely to stultify its development and to discourage ethically-orientated businesspeople; the difficulties involved in measuring and verifying corporate responsibility variables also argues against the over-judicialization of the field.

On the other hand, the effectiveness of informal enforcement depends on many factors such as the financial incentives to violate social and moral norms. It may also be that, although the general public strongly disapproves of certain conduct, the disapproval remains mostly a private matter because it is not transformed into concrete and relevant action. These concerns seem to hold in the context of anti-competitive agreements among businesses: the expected financial gain can be significant, and the reputational penalty seems to be less significant.[21]

The other important question concerns *the role of law and the state* in the design of non-legal enforcement. For example, reputation effects can be deliberately influenced by laws and regulations. A topical example is the decision of the Estonian Ministry of Justice to publicly 'name and shame' parents who have failed to make maintenance payments after divorce. The reason for the decision seems to be that there have been difficulties in enforcing maintenance agreements through the court system.

---

[21] On the reputational costs of corporate crime generally, see Alexander (1999).

More generally, law plays a *supportive role* even when the principal method of enforcement is non-legal. Law strengthens social norms through its expressive function and may give them necessary moral support. The specific content of social norms may also depend on laws and regulations; for example, standards of fairness can be shaped by legal rules even when they are enforced non-legally. Finally, benign-big-gun strategies of regulation require that there exists the threat of powerful legal sanctions, which to facilitate cooperation between regulators and regulatees on a more flexible basis.

4 CONCLUSION

Legal and regulatory strategies could be improved in two ways. Firstly by looking beyond laws and regulations to the realm of social norms and other sources of normativity that govern human choosing and acting, and secondly by becoming more conscious of the role of motivations, moral character and culture. These perspectives can fruitfully be translated into regulatory strategies that (i) align laws with positive social norms and motivations, (ii) seek to foster positive norms and cultivate moral habits, and (iii) rely, when appropriate, on moral and social norms for the enforcement of laws. The goal of this paper has not been to replace pre-existing wisdom, but to propose ideas that may give new insights and show directions for new initiatives. Its application in specific fields of regulation requires further discussion, experience and learning.

REFERENCES

Alexander, Cindy R. (1999), On the Nature of the Reputational Penalty for Corporate Crime: Evidence, *Journal of Law and Economics* 42(1), 489–526.

Allison, John R. and Lianlian Lin (1999), The Evolution of Chinese Attitudes Toward Property Rights in Invention and Discovery, *University of Pennsylvania Journal of International Economic Law* 20, 735.

Ariely, Dan (2008), *Predictably Irrational: The Hidden Forces That Shape Our Decisions*, HarperCollins, New York.

Aristotle (1980), *The Nicomachean Ethics,* translated by D. Ross, revised by J. L. Ackrill and J. O. Urmson, Oxford University Press.

Ayres, Ian and John Braithwaite (1992), *Responsive Regulation: Transcending the Deregulation Debate,* Oxford University Press, Oxford and New York.

Baldwin, Richard and Martin Cave (1999), *Understanding Regulation: Theory, Strategy, and Practice*, Oxford University Press, Oxford.

Bardach, Eugene and Robert A. Kagan (1982), *Going by the Book: The Problem of Regulatory Unreasonableness*, Temple University Press, Philadelphia.

Bauman, Yoram and Elaina Rose (2011), Selection or indoctrination: Why do economics students donate less than the rest?, *Journal of Economic Behavior & Organization* 79(3), 318–327.

Beito, David T. (2000), *From Mutual Aid to the Welfare State: Fraternal Societies and Social Services*, University of North Carolina Press.
Berman, Harold J. (1983), *Law and Revolution: The Formation of the Western Legal Tradition*, Harvard University Press.
Bernstein, Lisa (1996), Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms, *University of Pennsylvania Law Review* 144, 1765–1823.
Binmore, Ken (2005), *Natural Justice*, Oxford University Press, Oxford.
Binmore, Ken (2004), Reciprocity and the Social Contract, *Politics, Philosophy and Economics* 3(1), 5–35.
Boettke, Peter (1998), Why Culture Matters: Economics, Politics and the Imprint of History, *LSE-AMA-gi: Journal of the LSE Hayek Society* 2(1), 9–16.
Bowles, Samuel (2008), Policies Designed for Self-Interested Citizens May Undermine 'Moral Sentiments': Evidence from Economic Experiments, *Science* 320, 1605–1609.
Buchanan, James M. (1994), Choosing What to Choose, *Journal of Institutional and Theoretical Economics* 150, 123–135.
Charny, David (1990), Nonlegal Sanctions in Commercial Relationships, *Harvard Law Review* 104, 375–467.
Coase, Ronald (1991), The Institutional Structure of Production, The Alfred Nobel Memorial Prize Lecture in Economic Science, delivered 9 December 1991. Reprinted in Ronald Coase, *Essays on Economics and Economists*, University of Chicago Press, Chicago and London, 1994.
Cooter, Robert (1996), Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant, *University of Pennsylvania Law Review* 144, 1644–1696.
Cooter, Robert D. (2000), Law from Order: Economic Development and the Jurisprudence of Social Norms, in Mancur Olson and Satu Kähkönen (eds.), *A Not-so-dismal Science: A Broader View of Economies and Societies*, Oxford University Press, 228–244.
Cowell, F. A. (1992), Tax Evasion and Inequity, *Journal of Economic Psychology* 13(4), 521–543.
Dal Bó, Ernesto and Pedro Dal Bó (2010), 'Do the Right Thing': The Effects of Moral Suasion on Cooperation, NBER Working Paper No. 15559.
Deci, Edward L. with Richard Flaste (1995), *Why We Do What We Do: The Dynamics of Personal Autonomy*, Putnam, New York.
Eisenberg, Rebecca S. (1987), Proprietary Rights and the Norms of Science in Biotechnology Research, *Yale Law Journal* 97, 171–231.
Frank, Björn and Günther G. Schulze (2000), Does economics make citizens corrupt?, *Journal of Economic Behavior & Organization* 43(1), 101–113.
Frank, Robert H. (1987), If Homo Economicus Could Choose His Own Utility Function, Would He Want One with a Conscience? *American Economic Review* 77, 593–604.
Frank, Robert H. (1988), *Passions within Reason: The Strategic Role of the Emotions*, W. W. Norton, New York.
Frank, Robert H., Thomas Gilovich and Dennis T. Regan (1993), Does Studying Economics Inhibit Cooperation?, *Journal of Economic Perspectives* 7(2), 159–171.
Frank, Robert H., Thomas Gilovich and Dennis T. Regan (1996), Do Economists Make Bad Citizens?, *Journal of Economic Perspectives*, 10(1), 187–92.
Frey, Bruno S. (1993), Does monitoring increase work effort? The rivalry with trust and loyalty, *Economic Enquiry* 31, 663–670.

Frey, Bruno S. (1997), *Not Just For the Money: An Economic Theory of Personal Motivation*, Edward Elgar, Cheltenham, UK.

Frohlich, Norman and and Joe A. Oppenheimer (1996), Experiencing Impartiality to Invoke Fairness in the N-PD: Some Experimental Results, *Public Choice* 86, 117–135.

Fukuyama Francis (1995), *Trust: The Social Virtues and the Creation of Prosperity*, Free Press, New York.

Fung, Jill Chiang (1996), Can Mickey Mouse Prevail in the Court of the Monkey King? Enforcing Foreign Intellectual Property Rights in the People's Republic of China, *Loyola of Los Angeles International and Comparative Law Journal* 18, 613.

George, Robert P. (1993), *Making Men Moral: Civil Liberties and Public Morality*, Clarendon Press, Oxford.

Gregg, Samuel (2003), *On Ordered Liberty: A Treatise on the Free Society*, Lexington Books, Lanham, MD.

Hayek, Friedrich A. (1960), *The Constitution of Liberty*, University of Chicago Press.

Hayek, Friedrich A. (1973), *Law, Legislation and Liberty: Volume 1 – Rules and Order*, University of Chicago Press.

Hume, David (1898), *David Hume: The Philosophical Works*, edited by T. H. Green and T. H. Grose, Longmans, Green and Co, London.

Jacobs, Jane (1961), *The Death and Life of Great American Cities*, Random House, New York.

Johnson, Byron (2003), *The InnerChange Freedom Initiative: A Preliminary Evaluation of a Faith-Based Prison Program*, Center for Research on Religion and Urban Civil Society, University of Pennsylvania.

Juurikkala, Oskari (2007), Pensions, Fertility and Families, *Economic Affairs* 27(4), 52–57.

Juurikkala, Oskari (2009), Law and Social Norms in Contractual Relationships, *Helsinki Law Review*, 49–68.

Kohn, Alfie (1993), *Punished by Rewards: The Trouble with Gold Stars, Incentive Plans, A's Praise, and Other Bribes*, Houghton Mifflin, Boston.

Laband, David N. and Richard O. Beil (1999), Are Economists More Selfish Than Other 'Social' Scientists?, *Public Choice* 100(1-2), 85–101.

Law Commission (2006), *Murder, Manslaughter and Infanticide*, Law Com No 304.

Leoni, Bruno (1991), *Freedom and the Law*, expanded third edition, Liberty Fund, Indianapolis. Originally published in 1961.

Menell, Peter S. (2000), Intellectual Property: General Theories, in Boudewijn Bouckaert and Gerrit De Geest (eds.), *Encyclopedia of Law and Economics, Volume II: Civil Law and Economics*, Edward Elgar, Cheltenham, 129–188.

Mercuro, Nicholas and Steven G. Medema (2006), *Economics and the Law*, second edition, Princeton University Press.

Merton, Robert C. (1973), *The Sociology of Science*, University of Chicago Press, Chicago.

Mitchell, Lawrence E. (1999), Understanding Norms, *University of Toronto Law Journal* 49, 177–248.

North, Douglass (1990), *Institutions, Institutional Change, and Economic Performance*, Cambridge University Press.

Ogus, Anthony (2000), Self-Regulation, in Boudewijn Bouckaert and Gerrit De Geest (eds.), *Encyclopedia of Law and Economics, Volume V: The Economics of Crime and Litigation*, Edward Elgar, Cheltenham, 587–602.

Ostrom, Elinor (2000), Collective Action and the Evolution of Social Norms, *Journal of Economic Perspectives* 14(3), 137–158.

Panther, Stephan (2000), Nonlegal Sanctions, in Boudewijn Bouckaert and Gerrit De Geest (eds), *Encyclopedia of Law and Economics, Volume I: The History and Methodology of Law and Economics*, Edward Elgar, Cheltenham, 999–1028.

Partnoy, Frank (2003), *Infectious Greed: How Deceit and Risk Corrupted the Financial Markets*, Henry Holt, New York.

Peterson, Christopher and Martin E. P. Seligman (2004), *Character Strengths and Virtues*, Oxford University Press, Oxford.

Pieper, Josef (1966), *The Four Cardinal Virtues*, University of Notre Dame Press, South Bend.

Pildes, Richard H. (1996), The Destruction of Social Capital through Law, *University of Pennsylvania Law Review* 144, 2055–2077.

Posner, Eric A. (2000), *Law and Social Norms*, Harvard University Press, Cambridge, MA, and London.

Putnam, Robert D. (2000), *Bowling Alone: The Collapse and Revival of American Community*, Simon & Schuster, New York.

Rabin, Matthew (1993), Incorporation Fairness into Game Theory and Economics, *American Economic Review* 83, 1281–1302.

Riker, William H. (1976), Comments on Vincent Ostrom's Paper, *Public Choice* 27, 13–15.

Staw, Barry M. (1976), *Intrinsic and Extrinsic Motivation*, General Learning Press, Morristown, NJ.

Stigler, George J. and Gary S. Becker (1977), De Gustibus Non Est Disputandum, *American Economic Review*, 67(2), 76–90.

Stringham, Edward Peter (2011), Embracing morals in economics: The role of internal moral constraints in a market economy, *Journal of Economic Behavior & Organization* 78, 98–109.

Sunstein, Cass R. (1996a), On the Expressive Function of Law, *University of Pennsylvania Law Review* 144, 2055–2077.

Sunstein, Cass R. (1996b), Social Norms and Social Roles, *Columbia Law Review* 96(4), 903–968.

Tocqueville, Alexis de (1969), *Democracy in America*, Doubleday, Garden City, N.Y. Originally published in two volumes in 1835 and 1840.

Veljanovski, Cento (2007), *The Economics of Law*, Institute of Economic Affairs, London.

Vihanto, Martti (2003), Tax Evasion and the Psychology of the Social Contract, *Journal of Socio-Economics* 32, 111–125.

Watson, Alan (1993), *Legal Transplants: An Approach to Comparative Law*, second edition, University of Georgia Press, Athens, Georgia.

Wight, Jonathan B. (2005), Adam Smith and Greed, *Journal of Private Enterprise* 21, 46–58.

Williamson, Oliver E. (1983), Credible Commitments: Using Hostages to Support Exchange, *American Economic Review* 73, 519–540.

Williamson, Oliver E. (2000), The New Institutional Economics: Taking Stock, Looking Ahead, *Journal of Economic Literature* 38(3), 595–613.

Wils, Wouter P. J. (2006), Optimal Antitrust Fines: Theory and Practice, *World Competition* 29(2), 183–208.

Winn, Jane Kaufman (1994), Informal Financial Practices of Small Business in Taiwan, *Law and Society Review* 28, 193–241.

Yezer, Anthony M., Robert S. Goldfarb and Paul J. Poppen (1996), Does Studying Economics Discourage Cooperation? Watch What We Do, Not What We Say or How We Play, *Journal of Economic Perspectives* 10(1), 177–86.

Young, H. Peyton (1998), Social norms and economic welfare, *European Economic Review* 42, 821–830.

Young, H. Peyton (2008), Social Norms, in Steven N. Durlauf and Lawrence E. Blume (eds.), *The New Palgrave Dictionary of Economics Online*, second edition, Palgrave Macmillan, http://www.dictionaryofeconomics.com/article?id=pde2008_S000466 (19.3.2012).

Essay 4

Law and Virtue: An Economic Analysis

ABSTRACT

Classical virtue theory has received limited attention in economics. The paper demonstrates its fruitfulness for but economic and legal analysis by linking the traditional ethical literature with modern law and economics. Virtues are interpreted as a theory of moral psychology, and applied to economic theory, with comparisons against other behavioral models in economics. It is found that the virtue factor has major significance in economic life.

The paper also outlines a general framework for the analysis of law from a virtue-based perspective, showing how optimal legal design depends on the level of virtue of the citizens. Six general principles are identified: (1) virtue goes together with more freedom, while lack of virtue calls for more legal and regulatory constraints; (2) virtue goes together with more demanding law, while lack of virtue calls for less demanding law; (3) virtue goes together with more precise laws, while lack of virtue calls for less legal precision; (4) virtue goes together with broad standards, while lack of virtue calls for narrow rules; (5) virtue goes together with lighter enforcement and sanctions, while lack of virtue calls for harsher punishments; and (6) virtue goes together with more participation in law-making and law-enforcement, while lack of virtue implies less participation.

It is shown that there are various ways of gathering information about the level of virtue in society, and that laws and regulations may be designed in ways that account for the moral heterogeneity of the citizens. Finally, it is found the law plays a major role in promoting and safeguarding virtues, but legal perfectionism may be counterproductive.

CONTENTS

1 INTRODUCTION........ 3
2 VIRTUE THEORY: AN INTRODUCTION........ 3
2.1 Habits: Temperament vs. Character........ 4
2.2 Cardinal Virtues........ 5
2.3 The Unity of Virtues........ 6
2.4 Criticism: Stability, Universality and the Role of Culture........ 7
3 VIRTUE AND ECONOMICS........ 8
3.1 Virtues in Economic Literature........ 9
3.2 Comparison with Other Models in Economics........ 11
3.2.1 The Standard Model: Rational Choice........ 11
3.2.2 The Behavioral Model: Economics and Psychology........ 19
3.2.3 Human, Cultural and Moral Capital........ 24
3.3 Economic Benefits of Virtue (and Costs of Vice)........ 25
3.3.1 Prudence........ 26
3.3.2 Justice........ 27
3.3.3 Fortitude........ 30
3.3.4 Temperance........ 31
4 LAW AND VIRTUE: TOWARDS AN ECONOMIC ANALYSIS........ 32
4.1 Three Types of Economic Analysis of Law........ 32
4.2 Static Analysis: Optimal Law with a Fixed Level of Virtue........ 33
4.2.1 Virtue and Freedom (Legal Constraints)........ 34
4.2.2 Virtue and the Demands of Law........ 36
4.2.3 Virtue and Legal Precision........ 38
4.2.4 Virtue and Rules vs. Standards........ 39
4.2.5 Virtue and Legal Sanctions........ 41
4.2.6 Virtue and the Making and Enforcement of Law........ 42
4.3 Some Difficulties and Responses........ 43
4.3.1 Lack of Information........ 44
4.3.2 Heterogeneity: Legal Responses........ 45
4.4 Dynamic Analysis: Safeguarding and Promoting Virtue........ 47
4.4.1 Law *and* Virtue: A Positive Effect........ 48
4.4.2 Law *or* Virtue: A Negative Effect........ 52
4.4.3 Beyond Law: Other Dangers of Legal Perfectionism........ 55
4.4.4 A Synthesis........ 56
5 CONCLUSION........ 58
REFERENCES........ 58

1 INTRODUCTION

The notion of virtues has received limited attention in economics. This essay argues that the classical theory of virtues provides a fruitful perspective for both economic and legal questions. The argument if structured as follows. First, the principal concepts and ideas of classical virtue theory are explained. Second, the notion of virtue is analyzed in the context of economics, comparing the assumptions of virtue theory with those of modern economics, and demonstrating the practical importance of virtues in economic life. Third, a general framework is developed for analyzing the role of virtues in the economic analysis of law, showing how the optimal design of law depends on the level of virtue of the citizens.

2 VIRTUE THEORY: AN INTRODUCTION

This section provides a short introduction to the fundamentals of classical virtue theory. In ancient Greek philosophy, virtues were understood as perfections of character, acquired through the repetition of good acts. At least since Plato, the idea of the virtues was organized around the four cardinal virtues: prudence, justice, fortitude, and temperance.[1] In his *Nicomachean Ethics*, Plato's student Aristotle developed a rich account of the theory of virtues, and subsequent literature has tended to take it as the fundamental point of reference (see Aristotle, 1980). In recent decades, academic philosophy and psychology have witnessed a kind of renaissance of virtue ethics.[2] Now, the interesting question for our purposes is not the *ethical and normative* dimension of virtues, but rather the theory of virtues as a *descriptive* account of the perfection of human personality. There is a rich literature of this "moral psychology" view of virtues that takes into account more recent work in psychology (see Peterson and Seligman, 2004, and the references cited therein).

In what follows I will first explain the notion of habit, and then outline the cardinal virtues and show how they are related to each other. I finish by discussing the question of whether virtue theory is universally applicable.

---

[1] The four-fold distinction appears in Agathon's speech in praise of Love in Plato's *Symposium*. It probably has an earlier origin, as Pieper (1966: xi) points out: "An avant-garde intellectual who, incidentally, is the host of the famous banquet, Agathon offers no special reasons for this approach. That is, the contemporaries of Socrates already took for granted these traditional categories sprung from the earliest speculative thinking." Later writers have sought to justify the idea of four cardinal virtues by linking them to different faculties of human persons: intellect, will, and two generic types of passion or emotion called irascible and concupiscible passion.

[2] See for example Pieper (1966), Geach (1977), Foot (1978), MacIntyre (1984) and Kruschwitz and Roberts (1987). See also Peterson and Seligman (2004) for an extensive discussion of virtues by leading psychologists.

2.1 Habits: Temperament vs. Character

According to the classical doctrine of virtue, no one is born virtuous or excellent. In each person there are passions (emotions, feelings and impulses) that militate against the correct and reasonable exercise of one's freedom. One of the principal effects of virtue is to gain a greater harmony between reason, will and the passions. In the words of Aristotle (1980: I.13),

> "the impulses of incontinent people move in contrary directions. [Whereas] in the continent man [the soul] obeys [reason] – and presumably in the temperate and brave man it is still more obedient; for in him it speaks, on all matters, with the same voice as [reason]."

Another distinction is sometimes made between nature-given *temperament* and moral *character*.[3] The first is an innate reality, whereas the latter is shaped over time by education, environment and the exercise of one's freedom. Different temperaments imply that, in order to perfect one's personality and become truly virtuous, one has to struggle in different ways, depending on one's natural propensities. But temperaments as such are neither virtuous nor vicious.

The fundamental principle of virtue theory is that habits – virtues and vices – become stronger and more stable by way of *repetition*. Aristotle writes that "intellectual virtue in the main owes both its birth and its growth to teaching [...], while moral virtue comes about as a result of habit" (Aristotle, 1980: II.1). It is again clear that virtues do not arise in us by nature, but "we are adapted by nature to receive them, and are made perfect by habit" (ibid.).

It may be helpful to realize that the modern English word *habit* does not quite convey the meaning of Greek *hexis* or Latin *habitus* (see Sachs, 2005). Rather, the concept refers to a kind of ability – an inner strength, power or skill – that is developed by the constant and repeated exercise of virtuous acts. It also refers to various practical skills that are mastered by repeating the relevant acts: walking, doing sports, playing and instrument etc. Thus, by doing righteous deeds one becomes an increasingly and stably just person; similarly with acts that are prudent, courageous or temperate. On the other hand, the exercise of vicious acts – foolishness, injustice, cowardice, overindulgence and so on – fosters the weakening and degradation of moral character and, consequently, of the whole personality.

Implicit in the classical theory of virtue is the idea that there is certain *stability* about one's character, whether it be virtuous or vicious. That stability is translated into a tendency – weaker or stronger depending on the deep-rootedness of the virtue or the vice – to behave in accordance with one's character in future situations too. Therefore one cannot normally change one's

---

[3] The theory of temperaments is an important field in modern psychology, but its roots can be found at least in the work of Galen (AD 131–201), who described the four classical temperaments (melancholic, phlegmatic, sanguine and choleric).

character overnight for better or for worse, because character-change implies an inner transformation that requires the development of a *habitus*, which takes times and repetition.

The doctrine of virtues does not imply anything specific to the perennial question of how much of our personality is based on innate qualities as opposed to education, environment and other external factors. The theory is compatible with the fact that people may have all kinds of natural gifts as well as moral propensities that have an impact on later development. It does, however, underline the fact that the perfection of personality is a complex interplay of numerous factors that cannot really be separated from one another, even if we can conceptually distinguish them. Moreover, some personality traits that are commonly assumed to be natural or innate may not be so in fact. It is difficult for us to know such things with any precision, because the development of character starts straight after birth if not earlier. Often, what is seen as an innate trait may really be the result of the complex interaction between the educational and environmental conditions, on the one hand, and the free responses of the person in question, on the other hand, going back all the way to earliest childhood. Aristotle (1980: II.1) seemed to have this in mind when he wrote: "It makes no small difference, then, whether we form habits of one kind or of another from our very youth; it makes a very great difference, or rather *all* the difference."

2.2 Cardinal Virtues

The words that are used to signify specific virtues are not always understood correctly. Pieper (1966) repeatedly points out that contemporary language tends to depart significantly from the classical sense of the words that refer to the virtues. Therefore their traditional meaning is briefly outlined in the following.

Prudence as a cardinal virtue does not mean the timorous, danger-shunning, small-minded self-preservation that the word may bring to the modern mind. Rather, prudence is "the perfected ability to make good choices" (Pieper, 1966: 6) – nothing more, and nothing less. The notion of "good choice" here includes *technical* quality and skill as well as *moral* goodness. It is possible to analyze the different aspects of good choosing, but the cardinal virtue of prudence should be understood to encompass them all: in its perfect form, it is the firm and stable ability to make good choices – without any conditions.

The virtue of *justice* is not mere equity and fair play, but something much more interior to the person. In the words of Aquinas (1920: II-II, 58, 1): "Justice is a habit [*habitus*], whereby a man renders to each one his due with a constant and perpetual will." The specific requirements of the virtue of justice are a very complex question, which in fact is the principal question in ethics. What concerns us here is not the specific content of justice, but the general notion of justice as virtue: it is a stable and perfected volitional disposition of a person to

really *want* to fulfill the requirements of justice in each and every concrete situation.

Fortitude or *courage* is not fearlessness (which is actually a vice by way of a defect). In its classical essence, courage is readiness to fall in battle (Aristotle, 1980: III.6). But speaking more generally, courage is the perfected ability to stay the course and resist pressures of all kinds, whether that requires boldness and daring or endurance and patience (see Havard, 2007: 70-78; Pieper, 1966: 126-133).

Temperance or *self-control* is neither a fear of exuberance (which again would be a vice), nor mere moderation in eating and drinking. It is the ability to lead oneself to the good, i.e. to subordinate passions (emotions and feelings) to the spirit and direct them towards that which is *truly* and not only superficially *good* (see Havard, 2007: 80-90; Pieper, 1966: 145-152).

The classical approach organizes the virtues around these four cardinal virtues, but there are countless other virtues too, including thoughtfulness, decisiveness, kindness, gratitude, faithfulness, industriousness, cheerfulness, modesty, purity and so on. The various "minor" virtues can, however, be rooted in the cardinal virtues to which they are related by way of implication or analogy. Thus, for example, thoughtfulness and decisiveness are aspects of prudence; kindness, gratitude and faithfulness are different instances of justice; industriousness and cheerfulness flow from courage; and modesty and purity stems from self-control. The word *cardinal* stems from the Latin *cardines* meaning "hinges," because the other virtues move around and depend on the cardinal virtues. That is not to say that they are *less valuable*. A better way of understanding it is to say that it is precisely those more specific virtues that give *depth and content* to the (more general) cardinal virtues.

2.3 The Unity of Virtues

If one considers virtue theory as a mere list of different virtues, the multitude of virtues can seem perplexing, and one may wonder how it is possible to become truly virtuous if there are so many different excellences to be mastered and perfection to be acquired. One might also pose an objection to the classical theory of virtues by pointing out that, surely, prudence and fortitude sound like nice things, but they can also be used for evil purposes. The answer to these concerns can be found from another fundamental tenet of the classical doctrine, known as the *unity of virtues*.

This principle can be summed up in the saying, "Virtues grow together like the five fingers of the hand."[4] The systematic nature of classical virtue theory becomes evident if we consider the claim that *no virtue stands on its own*, as they are all intimately related to one another. The names given to different virtues are

[4] This famous saying is usually attributed to Aquinas (1920: I-II, 66, 2), but it is not a literal quotation.

simply means for analyzing and distinguishing, but real virtues are qualities of concrete persons, who cannot be sliced up and cut apart.

So, for example, justice and fortitude – as genuine virtues – are really different aspects of a whole. On the one hand, courage combined with the lack of justice can become a force for evil: "injustice corrupts the fruits of fortitude" (Pieper, 1966: 64-65). On the other hand, justice without courage is weak and unstable – and, hence, not really a virtue at all. Havard (2007: 121) puts it graphically:

> "Many politicians, lacking courage, make a travesty of justice. Think of Pontius Pilate and his brand of justice: 'I could find no substance in any of the charges you bring against him [Jesus of Nazareth] ... so I will scourge him...' Here is the frightening logic of a coward."

Similar connections can be found for the other virtues, too. For example, deep-seated intemperance – an uncontrolled craving for power, money and pleasures – spoils all the other virtues: it blinds the intellect, perverts the will, and makes a person cowardly (Pieper, 1966: 21-22, 203).

Although all the virtues need one another, *prudence* has a special role in the theory of virtues. The reason for the primacy of prudence is that, as the classical expression has it, prudence is the "measure" of justice, fortitude, temperance and all the other virtues (Pieper, 1966: 7). The meaning of this expression becomes clear when one considers the fact that the specifically moral virtues cannot guide themselves. It takes prudence – that is, the perfected ability to perceive the reality as it is and to make *good choices* – to see what each virtue requires in each concrete situation. Justice without prudence is mere "good intention" and "meaning well": it is a good start, but very far from perfection. Pieper (1966: 8) sums it up eloquently: "The intrinsic goodness of man [...] consists in this, that 'reason perfected in the cognition of truth' shall inwardly shape and imprint his volition and action."

2.4 Criticism: Stability, Universality and the Role of Culture

The classical theory of virtuous has encountered criticism, some of which is briefly mentioned here. A principal criticism is the claim that situational factors are more determining of choice than moral character; it is questionable to talk of virtues if all people respond to external pressures and incentives (Doris, 1998, 2002; Harman, 1999, 2000). One frequently cited support for this view is the famous Milgram experiment, in which many people obeyed an authority figure who instructed them to perform acts that conflicted with their conscience (see Milgram, 1963). However, the criticism seems unfounded, because such experiments are open to different interpretations. Advocates of virtues theory have responded by saying that the critics misconstrue the nature of character traits and misleadingly interpret limited empirical data (see Athanassoulis, 2000;

Kamtekar, 2004; Kupperman, 2001; Miller, 2003; Montmarquet, 2003; Sabini and Silver, 2005; Solomon, 2003; and Sreenivasan, 2002).

Another criticism is that people disagree on the content of the virtues, so the classical theory is not universally accepted. This claim raises fundamental questions about truth relativism, but, briefly, it is important to remember that the mere fact of disagreement is not a definitive proof one way or another. Moreover, it is interesting to note that disagreement about virtues ordinarily consists of disagreement on *what is virtuous*, not what the virtues are in their general form. In other words, people may have diverging views on what is the just and equitable solution to this or that moral dilemma, or how a courageous or self-controlled person should act in a concrete situation, but it is rare to find a person who – understanding the meaning of words – sincerely thinks that foolishness, injustice, cowardice and intemperance are good and admirable traits of personality.

The disagreement, therefore, principally concerns the practical application of the virtues to concrete situations, and it is only natural that there should be some variance of opinion, even within a specific culture and community. That is implied in the idea that prudence is the *measure* of all the virtues – and in matters of prudence, it is possible and in fact quite easy to err. A different problem arises when people do not care to act in accordance with the virtues, or do not even know that there are such things.

On the other hand, it is certainly true that the virtue ethics outlined here has its origins in Greek philosophy. One unavoidable consequence is that the language employed is specifically Western. However, many cultures have ethical traditions which closely resemble Western virtue ethics, or at least exhibit elements of it. For example, there is a growing comparative literature on Aristotelian and Confucian ethics, demonstrating the great similarities of these traditions despite very different linguistic concepts.[5] It has also been argued that there are certain fundamental personality traits that are admired – or despised – by others across cultures (see Lewis, 2001: Annex 1). One reason why we may fail to notice it is that we tend to focus on differences – the similarities are sometimes *too obvious* to attract our attention.

3 VIRTUE AND ECONOMICS

It is surprising to find that the notion of virtues has received practically no systematic treatment in modern economics. On the other hand, there are numerous minor comments and side remarks to virtues in economic literature (and much more in the broader field of social and behavioral sciences).

---

[5] See especially Yu (1998, 2007) and Sim (2007, 2010). MacIntyre (1991, 2004) is skeptical, but believes these traditions can engage in fruitful dialogue.

In what follows, I will first provide an outline of some of the economic literature that touches upon virtue theory. I will then analyze how that theory differs from the assumptions concerning rationality and behavior in some branches of contemporary economics. Finally, I try to provide a sketch of the various specifically economic benefits of virtues.

3.1 Virtues in Economic Literature

There are at least two possible reasons why virtue theory has not been systematically studied in economics. One is that the classical theory fell out of fashion some time during what is now called the modern period in European history (see MacIntyre, 1984; McCloskey, 2008). Other theories of ethics, from Bentham's utilitarianism to Kant's deontology, replaced the classical tradition. Until quite recently, virtues were conceived of as odd and archaic concepts of little interest to others than Classics students.

The second reason is that virtue theory is principally understood as an ethical theory. In fact, when the notion of "virtue" appears in economic literature, it is often understood not in the classical, Aristotelian sense of human perfection, but merely as a synonym for "ethics" or "justice" (see for example, Vogel, 2005). Of course, virtue theory *is* an ethical theory, too – but it is also a theory about human nature, psychology and behavior.[6]

Nevertheless, there have been many references to virtues in economic literature broadly understood. It is not possible to give an exhaustive review here, but some of the key contributions should be mentioned.

In early modern economics, Adam Smith is the obvious example of a thinker who was also interested in the virtues. Although he is primarily famous for *The Wealth of Nations* ([1776] 1976), which is seen by some as an apology for greed and selfishness, the reality is more complicated. Smith was principally a moral philosopher, and his other published book, *The Theory of Moral Sentiments* ([1759] 1976), was broadly in the tradition of virtue ethics (McCloskey, 2008).[7] Smith did not develop a virtue-based theory of economics, but out-of-context quotations

---

[6] In this respect virtue theory in the broader sense resembles Bentham's utilitarianism, which is both an ethical and a psychological theory. His psychological hedonism is not a normative theory, but an attempt to describe actual human behavior. In the opening passage of the *Introduction to the Principles of Morals and Legislation*, Bentham ([1789] 1970: ch. 1) writes:

> "Nature has placed mankind under the governance of two sovereign masters, *pain* and *pleasure*. It is for them alone to point out what we ought to do, as well as to determine what we shall do. On the one hand the standard of right and wrong, on the other the chain of causes and effects, are fastened to their throne. They govern us in all we do, in all we say, in all we think: every effort we can make to throw off our subjection, will serve but to demonstrate and confirm it."

[7] The tense relationship between Smith's two major works – the "Adam Smith problem" – remains an object of study among historians of thought. For an explanation and an attempt to resolve the problem, see Otteson (2000, 2002, 2011) as well as McCloskey (2008).

fail to do justice to the fact that he was deeply convinced that certain fundamental virtues were part and parcel of the functioning of a good society (Fitzgibbons, 1995).

Closer to our times, Max Weber's *The Protestant Ethic and the Spirit of Capitalism* ([1905] 1958) is an important work that highlights the role of moral – and religious – outlook in economic development. Weber argued that capitalism was rooted in a particular state of mind, which subordinated emotion, custom, traditional, folklore and myth to the domination of instrumental rationality.[8] This type of rationality, according to Weber, was common among the ascetically-inclined Protestants. Weber's general thesis has subsequently been challenged on both theoretical and empirical levels, but it remains an important contribution to the workings between moral outlook and economic life.[9]

Irving Fisher's classic *Theory of Interest* (1930) is also especially interesting, because it often mentions personal characteristics that contribute to, or lessen, impatience in the use of money. Among characteristics that lessen impatience are found foresight, self-control, thrift, expectation of a long life, and concern for welfare of family after death. Traits that contribute to impatience include short-sightedness, weak will, habit of spending freely, emphasis on the shortness and uncertainty of life, selfishness, and slavish following of whims of fashion.

Among contemporary economists, Deirdre McCloskey is probably the one that has expressed most systematic interest in virtue ethics. Her book *The Bourgeois Virtues: Ethics for an Age of Commerce* (2006) is a lively discussion of the ethics of market economics. However, it is more a philosophical journey, and an ethical defense of capitalism – not an attempt to create an economic theory that draws on the notion of virtues.

Despite these examples, references to virtues seem to be almost non-existent from in economic science today. One exception is Nobel-prize winning

---

[8] Weber (1958: 17) argues that a capitalist economy as such is not based on greed and avarice, but rather on the restraint of such irrational impulses:

> "The impulse of acquisition, the pursuit of gain, of money, of the greatest possible amount of money, has in itself nothing to do with capitalism. This impulse exists and has existed among waiters, physicians, coachmen, artists, prostitutes, dishonest officials, soldiers, nobles, crusaders, gamblers, and beggars. One may say that it has been common to all sorts and conditions of men at all times and in all countries of the earth, wherever the objective possibility of it is or has been given. It should be taught in the kindergarten of cultural history that this naïve idea of capitalism must be given up once and for all. Unlimited greed for gain is not in the least identical with capitalism, and is still less its spirit. Capitalism *may* even be identical with the restraint, or at least a rational tempering, of this irrational impulse."

[9] On the theoretical level, Weber describes incorrectly both Calvinism and pre-Reformation Catholicism (see Gregg, 2007: 4-6). On the empirical level, it has been shown that capitalism began to emerge at least a century before Luther and Calvin, especially in the city-states of Northern Italy (see Fanfani, 1984). These critiques show that Weber's "Protestant ethic" thesis is misplaced, but they do not reduce the value of his analysis on the impact of ethical outlook on economic life.

economist Kenneth Arrow, who once famously said: "It can be argued that the presence of what are in a slightly old-fashioned terminology called *virtues* in fact plays a significant role in the operation of the economic system" (Arrow, 1972: 345). However, it remained an unelaborated comment in a philosophical paper discussing the role of altruism in social life.

3.2 Comparison with Other Models in Economics

Different approaches in economics have both differences and similarities with the virtue-based view of human behavior. Three approaches are contrasted here with virtue theory: (1) the standard or *rational choice* theory, (2) the *behavioral* approach drawing from psychology, and (3) the theory of *human capital* and its different varieties. The virtue theory can be seen as combining elements of the first two approaches, although it also differs from both. The third view (human capital) is a more specific theory that could be fruitfully employed to explain some of the implications of virtues to economics.

3.2.1 The Standard Model: Rational Choice

The standard model in neoclassical economics, sometimes known as rational choice theory, holds that people act according to personal utility maximization, given a set of stable preferences and constraints. This vision of choice, which is akin to a maximization calculus, is subject to continuous debate. In its extreme form, the rational choice model has best been summarized by Becker (1976: 14, emphasis added):

> "The heart of my argument is that human behavior is not compartmentalized, sometimes based on maximizing, sometimes not, sometimes motivated by stable preferences, sometimes by volatile ones, sometimes resulting in an optimal accumulation of information, sometimes not. Rather, *all human behavior* can be viewed as involving participants who *maximize their utility* from a *stable set of preferences* and accumulate an *optimal amount of information and other inputs* in a variety of markets."[10]

There are, of course, many different conceptions of rationality.[11] But instead of labels like that, what concern us principally are the specific assumptions of rational choice theory, and how they differ from the assumptions of virtue theory.

Naturally, there are divergent opinions among economists on both the content and the applicability of these assumptions. Many economists are

---

[10] Elsewhere (p. 5), Becker writes: "The combined assumptions of maximizing behavior, market equilibrium, and stable preferences, used relentlessly and unflinchingly, form the heart of the economic approach as I see it."

[11] See MacIntyre (1989), Sen (1977; 1987: 10-28).

reluctant to extend the rational choice model far beyond the realm of material production and exchange in a market setting.[12] Likewise, most economists do not suppose that their fundamental assumptions are *literally true*. Rather, they are a useful simplification, which renders their analysis easier and more robust. What matters is that they yield clear and fruitful predictions.[13] A further defense of rational choice theory is that, although it is not true of everyone's behavior, it may be *true generally*, because competitive conditions force people to adapt and those who fail to maximize their preferences will fail.[14]

There are different ways of understanding the meaning of the fundamental terms and assumptions. I will briefly comment on three of them – utility maximization, preferences and self-interest – and will then discuss the compatibility of virtue theory with the rational choice model.

3.2.1.1 Utility Maximization

The principal assumption of rational choice theory is that choice is based on utility maximization. What follows from this assumption is a kind of choice determinism: when both the internal objectives (preferences) and the external options and constraints (budget and prices) are given, choice follows. Machina (1987: 124-125, emphasis added) explains:

> "[In the expected utility model] we assume that the objects of choice, either commodity bundles or lotteries, can be unambiguously and objectively described, and that situations which ultimately imply the same set of availabilities (e.g. the same budget set) *will lead to the same choice*. [W]e also assume that the individual is able to perform the mathematical operations necessary to actually determine the set of availabilities, e.g, to add up the quantities in different size containers or calculate the probabilities of compound or conditional events. Finally [...] we assume that preferences are transitive, so that if an individual prefers one object (either a commodity bundle or a risky prospect) to a second, and prefers this second object to a third, he or she will prefer the first object to the third."

---

[12] For example, Coase (1994). See (Becker, 1993: 3-4) for other references and criticism of this kind of behavioral compartmentalization.

[13] In the famous words of Friedman (1953: 14):

> "In so far as a theory can be said to have 'assumptions' at all, and in so far as their 'realism' can be judged independently of the validity of predictions, the relation between the significance of a theory and the 'realism' of its 'assumptions' is almost the opposite of that suggested by the view under criticism. Truly important and significant hypotheses will be found to have 'assumptions' that are wildly inaccurate descriptive representations of reality, and, in general, the more significant the theory, the more unrealistic the assumptions (in this sense)."

[14] See North (1990: 19, 24) for a summary and critique of this kind of argument.

One of the interesting implications of the assumption of utility maximization is that there is no account of human weakness or genuine error. People can make *objectively* bad choices, but *subjectively* speaking their choices are always the best ones. In other words, rational actors always choose optimally, and attain the maximum welfare that was within their reach, given their preferences and perceptions of the choices available to them.

As is explained later, preferences are assumed to be stable, which implies that people cannot change them. And, as far as perceptions of the options are concerned, these are due to natural capacities as well as acquired information. But even with respect to information that is costly to acquire, the standard model implies that people invest – deterministically – in the accumulation of information to the extent that the marginal benefit of better information equals the marginal cost of acquiring it (Stigler, 1961). Ultimately, therefore, if people make bad choices and end up being miserable, it is ultimately due to *bad luck*.

3.2.1.2 Stable and Revealed Preferences

"Preferences" – or "tastes" – form the underlying basis of the maximization calculus of the standard model, because they give rise to the objective function that is supposed to be maximized. The ordinary assumption in the standard model is that preferences are stable: "tastes neither change capriciously nor differ importantly between people. [Tastes] are there, will be there next year, too, and are the same to all men" (Stigler and Becker, 1977: 76). The fundamental reason for the assumption of *stable and unambiguous* preferences is practical, not philosophical:

> "The assumption of stable preferences provides a stable foundation for generating predictions about responses to various changes, and prevents the analyst from succumbing to the temptation of simply postulating the required shift in preferences to 'explain' all apparent contradictions to his predictions." (Becker, 1976: 5)

This is a complicated issue. In practice, economists often try to reduce the problem to clearly defined terms so that no complex assumptions of preferences are needed; ideally, it is assumed that all the variables can be measured in monetary terms, and thus people are only interested in money.[15] However, most contemporary economists hold that preferences can be complex. So, for example, Becker (1976: 5) explains that preferences "do not refer to market goods and services", but rather to "fundamental aspects of life, such as health, prestige, sensual pleasure, benevolence, or envy". The abstract modeling of such complex preferences is a subject of ongoing discussion (see Becker, 1996). Some authors have asked whether it is workable to extend preferences to such a wide range of

[15] See the notion of "economic man" (*homo economicus*) according to Jensen and Meckling (1994: 10).

objects, while continuing to claim that they are stable and unambiguous (Frank, 2004).

In addition to stability and non-ambiguity, preferences are assumed to be *revealed through choice*. The reason for this assumption is "the idea that the only way of understanding a person's real preference is to examine his actual choices" (Sen, 1977: 323). Naturally, this has been a contested assumption for decades. It is, however, important for the deterministic nature of the rational choice model, because it guarantees the identity between preferences and choice by way of a "definitional fix" (Sen, 2002: 6).

3.2.1.3 Self-interest

Amartya Sen begins his perhaps most famous article, entitled "Rational Fools", as follows:

> "In his *Mathematical Psychics*, published in 1881, Edgeworth asserted that 'the first principle of Economics is that every agent is actuated only by self-interest.' This view of man has been a persistent one in economic models, and the nature of economic theory seems to have been much influenced by this basic premise." (Sen, 1977: 317)

Thousands of pages have been written for and against the self-interest assumption in neoclassical economics, and the debate shows no signs of slowing down. A leading critic of the self-interest assumption, Amartya Sen writes in another work:

> "The self-interest view of rationality involves *inter alia* a firm rejection of the 'ethics-related' view of motivation. [...] To see any departure from self-interest maximization as evidence of irrationality must imply a rejection of the role of ethics in actual decision taking" (Sen, 1987: 15).

Naturally, there are many different ways of understanding the notion of self-interest, but the standard assumption in almost all of economic research is that people are simply looking after themselves, and ethical considerations do not enter into the picture (Sen, 1987: 7).[16]

---

[16] What Sen finds most inappropriate in this approach is that, in addition to taking an implausible assumption as fact, the standard approach *defines* rationality as equal to self-interested utility maximization:

> "Indeed, it may not be quite as absurd to argue that people always *actually* do maximize their self-interest, as it is to argue that *rationality* must invariably demand maximization of self-interest. Universal selfishness as *actuality* may well be false, but universal selfishness as a requirement of *rationality* is patently absurd. [...] To try to use the demands of rationality in going to battle on behalf of the standard behavioural assumption of economic theory (to wit, *actual* self-interest maximization) is like leading a cavalry charge on a lame donkey." (Sen, 1987: 16)

Part of the difficulty is that the concept of *self-interest* is so vague. If in earlier time it was common to speak of outright *egoism*, today, some economists will grant that, at least in principle, self-interest may include all kinds of *seemingly* non-selfish or even irrational motivations: "The analysis assumes that individuals maximize welfare *as they conceive it*, whether they be selfish, altruistic, loyal, spiteful, or masochistic" (Becker, 1992: 1). Although this concession seems to open the door to a wider range of considerations, it should be remembered that one fundamental issue remains unchanged: rational choice theory assumes that non-selfish behavior is a preference among others, and preferences are stable and, hence, *given* – not subject to rational deliberation and choice. Ultimately, again, the implication is that moral considerations are not *chosen* any more than one's liking of football instead of opera, or chocolate ice-cream instead of plain vanilla.[17]

In sum, the combination of utility maximization, stable and revealed preference, and self-interest create a *deterministic totality* in which one assumption feeds into the others:

> "The absolutist version of self-interest, together with the assumptions of stable preferences and maximizing behaviour, leads to a deterministic relationship among preferences, choice, and welfare [...]. Summing-up, we get a triple identity or full circle: self-interest is the only generic preference, which in turn is revealed through choice, and given that any choice advances individuals' welfare, personal welfare is the result of pursuing self-interest." (Rocha and Ghoshal, 2006: 592)

3.2.1.4 Comparison

The classical virtue-based theory of behavior and character is not absolutely hostile to the conventional theory of rational choice in economics. There are fundamental differences, but there are also important similarities.

First, virtue theory has an ambiguous relationship with the assumption of *utility maximization*. On the one hand, there are similarities: the Aristotelian theory of choice says that people naturally aim to be happy, and in this sense they always choose the option that they perceive as the best one. On the other hand, there is a major difference, which is that people will not always choose

[17] This, in my opinion, is the fundamental weakness of Robert Frank's (1987, 2004) various – in themselves very interesting – attempts to bring morality to bear on economics. In Frank's and others' work, morality is understood as a non-volitional preference, generally based on Adam Smith's classic work on *moral emotions*. Now, I agree that moral emotions exist and that they are an important part of human action, but they are not the whole picture of specifically *human* morality (they may, perhaps, be sufficient to explain "animal morality", so to speak). What they lack is the role of *moral intelligence and will* in the process of discerning what is truly good as opposed to only apparently attractive. Moral emotions provide only one input to this process, and they may be misleading in various ways.

correctly. Only a perfectly virtuous person will always choose optimally, whereas ordinary people are prone to a range of weaknesses of mind and will. Importantly, the classical theory holds that moral vice tends to distort one's perception of both one's needs and one's environment, thereby weakening and deforming the judgment of the intelligence.

Reflecting these concerns, Maxine Udall (2010) writes: "When the assumptions [of standard rational choice theory] do not hold, the consumer is a *preference maximizer*, not a *utility maximizer*" (emphases added). In that case, he will choose things that he finds attractive ("e.g. granite counter tops and large homes with en suite baths purchased with no money down and pick-your-payment mortgages"), but they are not those things that would actually make his life as good as it can be. On the other hand, Udall continues, "Assuming virtue in economic models of individual decision making is much the same as assuming full-information. If the assumption is true, revealed preference probably approximates utility maximization."

Secondly, a similar relationship can be found between virtue theory and the standard economic assumptions concerning *preferences*. On the one hand, virtue theory implies that preferences are likely to embody some sort of stability, because one's moral and intellectual character does not change overnight. In this respect, the notion of habits (good and bad) could be fruitfully built into economics, because it is not so prone to the accusation of *ad hoc* explanations.

On the other hand, there are major differences. People do change, and thus their underlying preferences for different things will change also. More importantly, preferences are never entirely *unambiguous*: human motivations are very complicated, and there are frequent tensions within the human person, forces pulling into different directions. In particular, emotions and passions, and intelligence and will, may be leading into opposing directions – especially when certain virtues are lacking. Thus, there is no absolute *internal consistency*, and consequently the notion of revealed preference becomes problematic. It may perhaps be suggested that virtues provide some inner harmony, and a virtuous person is able to harmonize different goods and ends (Rocha and Ghoshal, 2006: 604-606). Thus, again, it seems that the preference assumptions would be valid only for persons with perfected virtue.

Thirdly, virtue theory is not compatible with a narrow form of self-interest (egoism or selfishness). People are capable of sacrificing their personal interests for others', and many do so frequently. More importantly, one of the principal tenets of the classical theory is that human happiness or "flourishing" goes together with moral goodness, which again requires that one treats others with fairness and equity.[18] In other words, practicing the virtue of justice is a

[18] This is, however, not the same as J.S. Mill's famous dictum, "it is better to be a human being dissatisfied than a pig satisfied; better to be Socrates dissatisfied than a fool satisfied" (*Utilitarianism*, ch. 2). Virtue theory does not depend on any quality comparisons between different kinds of happiness – even if they be valid. Rather, the point is that a human being cannot, deep down, be

building-block of a good life, even if many other goods are needed also.[19] Thus, in Socrates' words, a person who does injustice is "to be pitied", because he cannot attain true happiness.[20] The claim is not that people willingly choose to harm themselves, but that they can be mistaken *not only about means*, but *also about the ends* of a good human life. We do not always correctly perceive what is truly good to us, and lack of moral perfection makes us prone to error about ends, too.[21]

On the other hand, it flows from this central principle that *virtue and self-interest in a deeper and truer sense go hand in hand*. In order to differentiate this from narrower forms of self-interest, it would be helpful to use some other term, such as *self-love* (even if that, too, can be found wanting). People can be, and are, motivated by things others than pleasure, sentiments or duty: virtue (personal excellence) transcends them and includes them all.[22] The compatibility between virtue and *reasonable self-love* is a fundamental aspect of the Aristotelian moral tradition, and it was held by later authors including Aquinas and several thinkers of the Scottish Enlightenment.[23]

---

happy and satisfied, if he lives like a pig. The only way of attaining genuine human happiness is to live well *as a human being*, which includes the practice of the human virtues.

[19] Aristotle's theory of happiness (or *eudaimonia*) nevertheless took it for granted that one may be unhappy because of bad luck etc. There is a slight difference in later, Christian versions of virtue ethics, which take into account the prospect of an afterlife and the idea that the practice of virtues in this life would, in any case, yield some form of compensation in the eternity.

[20] See Plato, *Gorgias*, 469; quoted in Pieper (1966: 48).

[21] Technically, it may be helpful to speak about *instrumental* and *substantive* rationality, referring to the discernment of means and ends, respectively. The cardinal virtue of prudence incorporates both of them. The statement that vices make us prone to error is implied in the *unity of virtues*.

[22] Rocha and Ghoshal (2006: 604) summarize their proposal:

> "The self-love view goes beyond a contingency approach because excellence [or virtue] is not a mutually exclusive fourth motivational category competing with pleasure, sentiments and duty; it is simultaneously present with them. [...] For example, more excellence may end achieving more wealth, but it is also possible for excellences to go up while achievement of wealth goes down; the search for excellence is also accompanied by good sentiments and pleasure, but it is not identified with them as in the case of smiling to a customer by the impulse of excellence when the feelings go in the opposite direction; finally, excellence, although different from duty, is intrinsically united to it, because one of the chief excellences is justice or the constant will of giving to others what is due. From the subject standpoint, excellence is specific to human beings and given their individual and social nature, excellence is beneficial to both the individuals who possess it and those who relate to them." (in-text references omitted)

[23] See Aquinas (1920: II-II, 44, 8, ad 2; 26, 5) and Finnis (1998: 113), whom Gregg (2007: 46 n. 8) summarizes as follows:

> "if a person is truly a friend to himself, then he should want a superabundance of the goods of reason and virtue for himself. Moreover [...], given that the goods of reason and virtue are goods for any human being, and that they include friendship and every form of harmony between persons, then this reasonable self-love helps to facilitate the realization of moral goods common to all."

In the end, we get a new *triple identity:* a perfectly virtuous person always chooses the best course of action available to him (maximization of utility), because he understands what is truly good to him and wants it with a constant will (stable and unambiguous preferences); this choice harmonizes the different human motives for action, and is thus compatible with his maximum well-being or happiness (self-interest or self-love). However, this triple identity is only valid for a perfectly virtuous person; others (which include all of us) depart from it in various ways, according to their degrees of moral perfection or imperfection.

1.2.1.5 Integration

A couple of points, finally, on the possibility of integrating virtue theory into the standard model. One possibility is to view virtues as *constraints* on choice. Instead of an external norm that controls and sanctions behavior, virtues would constitute an internal norm. In other words, persons with strong virtues would have a preference for continuing to practice those virtues, and unvirtuous conduct would imply lower utility. The general challenge with this kind of assumptions concerning preferences is that they are easily seen as arbitrary postulates. However, notes Panther (2000: 1008), "as survey techniques have become more and more sophisticated in other social sciences and experiments have gained general approval in economics, evidence on preferences can be obtained and tested far more reliably."

This kind of *preference or "taste" approach* works well for modeling moral emotions (or moral sentiments, as Adam Smith called them) including feelings of regret, remorse, shame, guilt or embarrassment (see Frank, 1987, 1988). However, it is less clear whether it is suitable for dealing with virtues and vices. Note, further, that the "self-love" view of motivation (self-interest understood in the deepest, moral sense) is one that sees "doing good" as something *attractive and motivating*. It is not a question of putting constraints on self-interest, but of understand the nature of goodness differently, and of pursuing the deeper human goods actively.

A different approach has been developed by Dal Bó and Terviö (2008) in their recent working paper, which develops a formal model of *self-esteem* that incorporates some Aristotelian insights. The model is however cumbersome, as it builds on a secularized "Weberian" (actually, Calvinist) idea that people are either "good" or "bad", but they do not know which ones they are; however, they want to appear good and therefore struggle to maintain a positive self-image. The Aristotelian feature of the model is that the actors are assumed to have "imperfect free will": they can choose their general intent (good or bad),

---

On virtue and self-love according to Scottish Enlightenment thinkers, see Gregg (2007: 17; 2009) and Hanley (2009).

but the actual choice is subject to random disturbances depending on whether one is good or bad by nature.

The model by Dal Bó and Terviö captures some of the insights of virtue theory, especially the idea of "moral capital", which grows as one performs good acts repeatedly and is more likely to perform good acts in the future (and vice versa with bad acts). In the authors' words, "the model accounts for the emergence of morality as a cumulative process of habituation through action, which parallels Aristotle's account of the attainment of virtue" (p. 5).

However, there are also weaknesses with the model. Many of its foundational assumptions are foreign to virtue theory, including the notion of innate goodness or badness of character, the assumption of time-consistent preferences, and the reduction of moral motivation to maintaining a good self-image. It is not surprising, therefore, that some of the implications of the model are problematic. For example, "bad individuals" may develop moral capital (only if they are so lucky as to never suffer "temptations"), but they will lose it completely if they perform even one bad act, after which they will only perform bad acts (pp. 16-17). In other words, bad guys cannot become good, and the idea of character development does not apply to them in any real sense.

3.2.2 The Behavioral Model: Economics and Psychology

Although the standard, rational choice model has persistently maintained its hegemony in economics, it has not been without challenges. North (1990: 18) summarizes:

> "In the past twenty years, this approach has come under severe attack [...] from experimental economic methods, research by psychologists, and other empirical work, all of which have revealed major empirical anomalies associated with this approach. Briefly, these fall into the following categories: violations of the transitivity assumptions, framing effect, where alternative means of representing the same choice problem can yield different choices; preference reversals, where the ordering of objects on the basis of their reported valuations contradicts the ordering implied in direct choice situations; and problems in the formulation, manipulation, and processing of subjective probabilities in uncertain choices."

The branch of economics that studies economic behavior in light of experimental psychology is commonly known as *behavioral economics* (see Camerer, Loewenstein and Rabin, 2004). There is strictly speaking no one behavioral theory, just as within the neoclassical paradigm there are many different ways of understanding and applying the notion of rational choice. The unifying theme of the behavioral approach can be summarized in two propositions (Rabin, 1998): (1) there are proven and empirically significant

departures from the simplistic rational choice model of behavior, and (2) these departures are systematic in the sense that they are non-arbitrary and hence (to some extent, at least) predictable and conformable to economic analysis.

As the starting point of behavioral economics is not deductive theory but empirical observation, there have been numerous different systematizations of the findings of behavioral research. One influential approach is to distinguish between *bounded rationality*, *bounded willpower*, and *bounded self-interest* (Jolls, Sunstein and Thaler, 2000). In what follows, these are briefly described and then compared with the virtue-based perspective.

3.2.2.1 Bounded Rationality

The notion of bounded rationality is based on the fact that the cognitive abilities of human beings are obviously not infinite. This was first highlighted by Herbert Simon, who argued that people do not always engage in optimization behavior, because many decision-making situations are so complex that they cannot be modeled and solved in the human mind as if they were mathematical exercises (see Simon, 1947, 1955). Instead, people sensibly resort to simplifying methods and what Simon called "satisficing", i.e. the search not for *optimal* choices but *good enough* ones.

Subsequent research, especially by Daniel Kahneman and Amor Tversky, elaborated on different ways in which human beings actually make choices (see Tversky and Kahneman, 1973, 1974). People have imperfect memories and limited brain power, and they resort to various mental shortcuts and rules of thumb (heuristics) in order to make it easier to cope with complexity and uncertainty. These methods are entirely sensible – indeed very necessary – but under identifiable conditions, they tend to lead to systematic departures from the predictions of idealized optimization behavior. These departures are common called *biases*.

Behavioral economics has identified a series of common biases (see generally Rabin, 1998). Salience bias says that people tend to give undue importance to memorable and vivid evidence, and too little importance to rationally more weighty contrary evidence. Optimism bias means that people tend to overestimate their chances of success, and underestimate chances of failure and risk to oneself. Overconfidence bias states that most people overestimate their ability to judge facts and circumstances. Hindsight bias says that people tend to give too much weight to events that really took place when assessing future probabilities. Confirmation bias means that people tend to emphasize information that supports their past decisions. Status quo biases denotes that people are attached to the present situation and demand more than rational choice theory predicts to justify departures from it. And so on.

3.2.2.2 Bounded Willpower

Bounded willpower refers to the idea that people do not always conform to the predictions of the rational choice model, however not because of informational complexity or similar reasons, but because they may not have enough willpower to carry out their premeditated plans. In other words, this captures the fact that passions and emotions influence our choices in ways that we cannot always control.

There are at least three important implications of bounded willpower. The first one is called projection bias, which means that people often falsely project current transient preferences on to the future (Loewenstein et al., 2003). For example, we give too much importance to benefits available now and downplay later costs. Projection bias is a form of time-inconsistent preferences. It takes place especially when we are overcome by powerful but transient emotional states, which compel us to do something that we regret later on.

The second implication is the procrastination bias, which is the tendency of people to leave for later tasks that they should carry out now (Akerlof, 1991, O'Donoghue and Rabin, 1999). For example, we often delay unpleasant tasks until the last minute, even if we really do not have any other important jobs to do. In a sense, procrastination bias (costs now, benefits later) and projection bias (benefits now, costs later) are just two sides of the same coin.

The third type of bounded willpower is addictive behavior, which is similar to the projection bias but seems to involve compulsiveness not present in ordinary circumstances (see Skog, 2005). Many people wish to adopt healthier lifestyles in the interest of long-term well-being, but find themselves unable to quick smoking, eating too much etc. Some economists have tried to reconcile addiction with rational choice (Becker and Murphy, 1988), but this is hardly convincing, because most cases of addiction violate such assumption as stable and unambiguous preferences (Skog, 2005: 119-124).[24]

3.2.2.3 Bounded Self-interest

Bounded self-interest means that people do not always act merely to advance their personal well-being, but are also interested in the well-being others – even when this implies personal sacrifices (Frank, 1988). Departures from narrow self-interest are also seen in so-called *fairness behavior*. For example, the famous "ultimatum game" experiments, which have been repeated under numerous variations, show that the far majority of people are willing to share resources

---

[24] "[Fully rational, forward-looking utility maximizers] always do what is best according to their own utility calculus. They have no motive for changing their consumption behavior and should not struggle to cut back. If they think it is best to cut back, they will cut back. And if they do not, they will simply continue. There is no room for ambivalence and struggling with oneself in standard rational choice theory. [...] In particular, Becker's theory has no room for typical addiction-related phenomena such as repeated remission and relapse." (Skog, 2005: 121)

with others even when they do not know each other and will not meet again (the average share given is 40%: see Oosterbeek et al., 2004).

While fairness behavior is not entirely predictable, some general principles have been identified (Rabin, 1993). On the one hand, people are willing to sacrifice more of their material well-being in order to help those who are or have been kind. On the other hand, they are willing to sacrifice their material well-being in order to punish those who are or have been unkind. Thus, for example, evidence from ultimatum games shows that most respondents reject offers that they consider unfair. Finally, fairness-based motivation is stronger when material stakes are smaller, and weaker when material stakes are larger.

3.2.2.4 Comparison and Integration

The behavioral model certainly portrays a more realistic picture of real human action than the simplistic rational choice model. It also incorporates some features that are implicit in the classical virtue theory, such as the fact that people not always choose optimally. The attempts to formally model the findings of behavioral economics also suggest a feasible approach to include the notion of virtues in mainstream economics.

However, it seems that the standard version of the behavioral approach could be fruitfully enriched by the insights of virtue theory. In terms of the classical cardinal virtues, we might say that *bounded rationality* is most closely related to the virtue of *prudence*; *bounded willpower* is related to *temperance* (projection bias especially) and *fortitude* (procrastination bias); and *bounded self-interest* is concerned with the virtue of *justice*.

Four differences and ideas for further development are outlined here. The first is that virtue theory may provide new insights to our understanding of the *differences in individual-level behavior*. A common implicit assumption in behavioral economics is that people tend to act in the same way, or at least to be subject to the same biases. However, it is readily granted that the biases are only broad tendencies, and one cannot make strong predictions about individual behavior. Virtue theory, on the other hand, implies that there may be significant – yet relatively stable – differences between individuals, depending on their good or bad habits (both intellectual and moral habits).

For example, the notion of prudence implies that people can learn to make better choices. In the behavioral economics literature, there are different opinions on the extent to which people are able to learn to avoid biases. Generally speaking, it seems that some biases can be mitigated through learning, but with others it is not clear; sometimes expertise may even increase biases such as overconfidence (see generally Rabin, 1998: 31-32). This is consistent with virtues. The classical concept of prudence implies that experience is necessary for learning to choose well, but the mere accumulation of facts does not constitute the virtue of prudence. Moreover, the overconfidence of experts may be understood as a byproduct of the professional *pride*, a vice that often comes

along with expertise, causing a weakening of some aspects of prudence, such as the ability to ask for advice and to listen to the opinions of others.

Secondly, virtue theory suggests a more nuanced theoretical framework for behavioral economics.[25] It seems that some of the biases are caused by the unavoidable fact that people need to resort to heuristics in order to cope with complex information, while others may be caused by bad moral and intellectual habits, i.e. vices. A detailed categorization would call for more extensive study, but for example, common errors in probabilistic estimation seem to be caused by natural, innate heuristics (although one may mitigate these errors by deliberately adjusting one's estimates as advised by experimental findings). On the other hand, other biases seem to be linked to lack of virtue: salience bias is partly caused by lack of systematic and rational reflection on issues; overconfidence may be caused by lack of experience of personal mistakes as well as lack of humility; and confirmation bias reflects undue emotional attachment to past decisions. The relationship between habits and biases seems to be strongest when it comes to bounded willpower: procrastination bias is almost identical with lack of fortitude, and projection bias is a form of intemperance. However, note that according to the classical theory, lack of prudence is often rooted in some moral vices: pride leading to overconfidence is only one example.

Thirdly, virtue theory may improve our understanding of the interaction between passions or emotions, habits, and choice. The language of behavioral economics sometimes suggests that people are forced to act in a certain way, as if human choice were the deterministic result of external and internal forces. This leaves out such factors as of rational deliberation, habit-formation, and freedom. Preferences are not stable and unambiguous, but complex and changeable.

Addictive behavior is one example. Some authors have argued that addiction should not be treated as a disease at all, but as a vice, a bad habit (Szasz, 1972). This is probably exaggerated, because addiction includes a peculiar element that goes beyond general weakness of will; the "withdrawal syndrome" is a physiological and neurological reality. On the other hand, it does not eliminate the possibility of free choice (Skog, 2000). There certainly are many people who have quit smoking or drinking. One way of seeing it is that addiction does not necessarily imply weakness of will (as in the vice of *laziness*), but the overcoming of addiction does imply strength of will and requires the formation of strong habits that counteract the psychological attraction of the addictive substance.

Fourthly, virtue theory suggests a deeper understanding of unselfish behavior. Again, a distinction between habits and other factors seems relevant. On the one hand, one's attitude and conduct towards others is in part rooted in

---

[25] It is widely acknowledged that the theoretical framework is in need of significant development: see Choi and Pritchard (2003: 9-11) and the references cited therein.

habits, especially in the cardinal virtue of justice (or lack thereof), as well as non-cardinal virtues related to justice, such as honesty, loyalty, generosity and charity. On the other hand, there are behavioral phenomena that do not seem to be rooted in acquired habits, but in innate *moral emotions*. For example, sympathy towards those who treat us kindly, and anger towards those who act unfairly are not based on habits but on emotions.

Virtue theory emphasizes the role of intelligence and will (as well as acquired habits) in moral behavior. Moral emotions are an important input, but they alone do not constitute human morality, because they, too, require deliberation about what is truly good and just. Moral emotions as such may be good, but they may also lead against justice, for example when feelings of anger grow strong (causing thirst for vengeance), or when unconstrained altruism and sympathy lead one to neglect other responsibilities and prior commitments. Virtue implies that moral emotions are channeled and controlled, and that one is not dependent on them alone. A virtuous person will not be driven to injustice by bad feelings, and will treat others fairly even when he does not experience feelings of sympathy.[26]

3.2.3 Human, Cultural and Moral Capital

A relatively novel approach that might fruitfully incorporate the idea of virtues is the study of non-materials forms of capital (see generally Becker, 1993; Schultz, 1971). In the analysis of *human capital*, the focus is, primarily, on education and training in practical skills. This is not far off from classical virtue theory, because in Aristotle's terminology, useful skills are another type of virtue, or excellence (*arête*). Moreover, it is interesting that, in the introduction to his *Human Capital*, Becker makes a passing reference to virtues:

> "Schooling, a computer training course, expenditures on medical care, and *lectures on the virtues of punctuality and honesty* are capital too in the sense that they improve health, raise earnings, or add to a person's appreciation of literature over much of his or her lifetime." (Becker, 1993: 15-16, emphasis added)

Within economics, the concept of virtues has not been systematically included in the study of human capital. However, there are various approaches that at least implicitly take notice of this concept. For example, the sociological concept of *social capital* is one which can be seen are indirectly related to virtues. In the simplest terms, social capital can be defined as "an aggregate of interpersonal networks" (Dasgupta, 2008). But taking a broader definition, social capital "refers to trust, concern for one's associates, a willingness to live by the

[26] As an aside, it would be interesting to conduct a longer-term ultimatum game experiment, tracking the behavior of specific individuals over longer periods of time. This would enable us to study the effects of habit-formation and virtue of justice (or lack thereof).

norms of one's community and to punish those who do not" (Bowles and Gintis, 2002: 419). In this sense social capital has both personal and communal dimensions, and includes certain habits that may be seen as virtues. Fukuyama (1995) also highlights the importance of social capital for the creation of trust, which in turn is necessary for wealth-creation and well-being: lack of social capital leads to higher transaction costs, legal expenses, increased legal regulation, and avoidance of cooperation.

A related notion is that of *cultural capital*. According to Sowell (1994, 1996), different peoples and cultures have their own particular characteristics, which may function as inter-generational transmitters of human capital. For examples, industriousness, thrift, appreciation of education and entrepreneurship are some of those characteristics that can be seen economically as a type of capital, because they facilitate long-term success and the productive capacity of a people or culture. The role of culture in explaining economic development was part of Weber's famous work ([1905] 1958), and recent literature on economic development (or lack thereof) argues that culture plays a fundamental role (see Arias, 2011; Harrison, 1993, 2000; Harrison and Huntington, 2001; Landes, 1999).

In leadership studies, classical virtue theory seems to have attracted more interest than in most other fields. The interesting thing for present purposes is the concept of *moral capital*, developed by Alejo Sison:

> "Moral capital may be defined as excellence of character, or the possession and practice of a host of virtues appropriate for a human being within a particular sociocultural context. Nowadays, its meaning could also be expressed by the word 'integrity', a trait suggesting wholeness and stability in a person as someone on whom others could depend or rely. Having virtues or an excellent character may be considered moral capital not only because they are a form of wealth, but also because they are productive capacities or powers that accumulate and develop in an individual, through proper investments of time, effort and other resources, including financial ones." (Sison, 2003: 31)

However, the notion as developed by Sison is not elaborated in the context of economic theory, so more work is needed.

3.3 Economic Benefits of Virtue (and Costs of Vice)

I now proceed to discuss some of the economic benefits of virtue, and the economic costs of vice. Naturally, this should be understood as a sketch of a very large set of issues, which also calls for more detailed study.[27] The following

[27] An interesting proposition was once made by Pope John Paul II in an address to the UN Economic Commission for Latin America and the Caribbean:

subsections discuss the link between economic efficiency and well-being, and each of the cardinal virtues.

3.3.1 Prudence

In standard economic analysis, as was explained earlier, it is assumed that people make optimal choices (at least *ex ante*), but it is obvious that this is not always so. The virtue of prudence is needed in order to make good choices. The classical notion of prudence is what philosophers call a "thick concept".[28] Prudence is the habitual ability to make good decisions *in the widest sense* – including morally good, and technically sound. A prudent person need not know everything, but one must be able to judge the situation correctly, find out the relevant information, consult competent people, and so forth.

The economic benefit of being able to make good decisions is perhaps too obvious, so it is useful to consider the question in some more detail. Drawing on the classical literature, Gregg (2008) lists several "integral parts of prudence," which highlight the different facets of this cardinal virtue. Prudence thus includes, among other things:

(i) open-mindedness and the willingness to make use of the experience of others (*docilitas* or *docility*);
(ii) the readiness to take risks while avoiding unnecessary and disproportionate risks (*caution*);
(iii) the willingness to study and compare different options (*discursive reasoning*);
(iv) the ability to anticipate future consequences and estimate the ability to particular actions to lead to the realization of our goals (*providentia* or *foresight*);
(v) an accurate, objective and true-to-reality memory (*memoria*);
(vi) the capacity to judge a situation quickly and by oneself when necessary (*solertia* or *shrewdness*); and
(vii) the ability to take all the relevant circumstances into account without becoming paralyzed by indecision (*circumspection*).

The contribution of the different parts of prudence to economic development and efficiency is quite obvious. Any investor, business executive or even a

---

"The moral causes of prosperity [...] reside in a constellation of virtues: industriousness, competence, order, honesty, initiative, frugality, thrift, spirit of service, keeping one's word, daring – in short, love for work well done. No system or social structure can resolve outside of these virtues, as if by magic, the problem of poverty. In the long run, both the projects of institutions and their functioning reflect the habits of human beings—habits that are acquired during the education process and that form an authentic work ethic." (John Paul II, 1987: 775-776; quoted in Finn, 1998: 677)

[28] Thick concepts in philosophy are ones that have a significant degree of descriptive content and also are evaluatively loaded. See generally Putnam (2002: 34-43) and Williams (1985).

housewife will need these capabilities in order to make sound economic decisions. Of course, the economic significance of this virtue will depend on the context; for example, an entrepreneur is especially in need of such prudential virtues as caution, foresight, shrewdness and circumspection in order to be successful.

Deficiencies of prudence will imply real economic costs in terms of bad decisions, lost opportunities and wasted resources. Gregg (2008) argues that the global financial crisis of 2008-09 was in great part caused by lack of prudence (as well as other central virtues, including justice). Certainly there were institutional issues too, but standard economic analysis fails to capture the different ways in which bad policies were also caused by lack of virtue. For example, many have argued that monetary policies in the US and elsewhere were misguided during the years leading to the crisis. Gregg goes on to explain how these mistakes related to lack of virtue:

> "There is little doubt that the Federal Reserve contributed to the bubble in house prices by lowering interest rates earlier in the decade and keeping them low. [...] It believed that interest rates could be lowered safely because the inflation rate was low. The problem, however, was that the Federal Reserve's inflation figures were flawed. It is often said that good central bankers know to be skeptical of data and to keep questioning it, if only to force economists to keep verifying it. But because they failed to do so, the Federal Reserve kept interest-rates low for far too long, thereby allowing a flood of cheap money to enter the market, much of which went into the housing boom. This was not simply policy-misjudgment in the sense that much monetary policy seems dominated today by the imperative of avoiding recessions at all costs, regardless of the fact that recessions are sometimes necessary to correct imbalances of equilibrium and to allow resources to be invested more efficiently. It also represents, I submit, profound failures of foresight, caution, humility, and discursive reasoning on the Federal Reserve's part."

A similar judgment could made of the numerous and complex policy mistakes leading to the European debt crisis that started in 2010 (see generally Wihlborg, Willett and Zhang, 2010). It is sometimes said (as also in relation to the 2008-09 financial crisis) that "no one predicted it", but that only masks the ignorance of the speaker; in reality, both crises were predicted by many, and the euro-area debt crisis was anticipated by some analysts even before the common currency got started (see Bagus, 2011; Feldstein, 1997).

3.3.2 Justice

Justice is often seen as an ethical end in itself, and certainly it is that in the virtue theory too. However, justice as virtue is also a major contributor to economic

well-being and efficiency. This is most evident when one considers the various costs caused by injustice. Writes Kant: "Man's greatest and most frequent troubles depend on man's injustice more than on adversity."[29]

In classical ethics, the notion of justice is often divided into three basic forms (Pieper, 1966: 71–72): *commutative or reciprocal justice* (relations of individual to individual), *distributive or ministering justice* (relations between the community and its individual members), and *legal or general justice* (the members' relations to the social whole). What concerns us here is not so much the hard questions of what exactly justice requires in different situations, but the social consequences of the virtue of justice, i.e. the stable willingness of members of a community to treat each other justly.

Each dimension of justice has its economic importance. Commutative or reciprocal justice is especially significant, because the moral questions that arise in trade and business are principally covered by commutative justice. Let us briefly look at each of the three basic forms of justice and their economic implications.

3.3.2.1 Commutative Justice

Firstly, commutative or reciprocal justice requires honesty, keeping one's word, fulfilling contracts (or at least compensating for non-fulfillment), restitution of damages, and so on. It is evident that commutative justice lies at the heart of commercial society, which is very dependent on *mutual trust* (Fukuyama, 1995). When promises are kept and contracts fulfilled, trade can operate smoothly and avoid significant *transaction costs*. In a society of perfectly just members, there would be no need the legal enforcement of contracts (although there might be a role for law to facilitate the peaceful making and settling of agreements).

If the culture-based theory of economic development (mentioned earlier) is broadly on the mark, it follows that the long-term economic consequences of justice (and injustice) are very significant. On the other hand, lack of reciprocal justice implies costs in individual cases too. Discussing the failure of the sub-prime mortgage market, Gregg (2008) notes that not only did many borrowers act imprudently, but both lenders and borrowers failed to practice elementary commutative justice:

> "An early 2008 BasePoint Analytics report states, for example, that almost 70% of mortgage early-payment defaulters made fraudulent misrepresentations on their original loan applications – that is, they *lied* about factors such as their income, assets, and liabilities. In other words, a good number of commercial arrangements, many of which were used as the foundation for an increasing number of securities and equities, were based on untruths about assets and untruths about persons."

[29] Kant (1925: 245); quoted in Pieper (1966: 43).

Likewise, many banks and mortgage brokers acted dishonestly to both their clients (giving misleading information about the risks of the contract) and their employers or investors (neglecting checks on some lenders' applications, packaging toxic deals into seemingly-low risk securities, etc.). The same criticism could be leveled against many people working for credit rating agencies, accounting firms and other gatekeepers.

It might be countered that emphasizing justice is misleading, because the real problem is the lack of prudence on the part of the counterparties, who were too gullible when they should have made the necessary checks and look after themselves. That is partly correct, but it also directs our attention to the diversity of mechanisms to deal with vice. As Gregg (2008) explains, there is a strong connection between a well-functioning financial market and virtues:

> "The word 'credit' is derived from *credere* – the Latin verb for 'to believe' but also 'to trust'. Thus, whether it is a matter of giving someone a credit-card for the first time, or extending a small business the capital that it needs to grow into a great enterprise, providing people with credit means that you trust and believe in them enough to take a risk on their insight, reliability, honesty, prudence, thrift, courage and enterprise: in short, the moral habits without which wealth-creation cannot occur."

Naturally, business is possible even when people are not perfectly virtues. However, when people do not treat each other justly, a whole array of expensive procedures and mechanisms have to been invented and employed in order to make commerce possible (see North, 1990: 11-16, 27-35). Besides, there are no mechanisms that completely eliminate the damaging effects of habitual or occasional injustice.

3.3.2.2 Distributive Justice

Commutative justice is particularly important economically, but the other two forms of justice should not be neglected either. Distributive or ministering justice includes the relations between the community and its individual members. It is useful, however, to note that distributive justice is not just a matter of the community *qua* community, but it must be exercised by all individuals too in their dealings with others. The difference with respect to commutative justice is that it is essentially exchange-based or reciprocal, while distributive justice is about relations between members of a community. This includes, among many things, contributing to common expensive in accordance with one's capacity, as well as voluntary charity to help those in need.

In terms of economics, distributive justice is relevant not only for the economic *well-being of the least fortunate members of the society*, but also for the *functioning of the society as a whole*. The creation and maintenance of such fundamental social and commercial institutions as secure property rights and

reliable courts of law is to a very large degree dependent on the justice of the individual members of the society as voters, public intellectual, politicians and civil servants. In contrast, lack of distributive or ministering justice leads to a range of social costs, ranging from ill-treatment of the poor to *corruption in public office and other forms of abuse of power*. The latter, in particular, will be a major obstacle to the efficient operation of the economic system and therefore to economic development.

Some authors have claimed that "corruption" may be economically efficient when it means that senseless or harmful regulations are not enforced by the authorities (Mironov, 2005). However, it is fundamental to understand that the virtue of justice does not necessarily demand that one enforces all the laws that are formally valid, because some laws may be senseless or harmful. Justice does not imply *blind obedience to the law*, but the active promotion of *the common good*, which in some special cases may even demand that one disobey the law (Finnis, 1980: 352-366).

3.3.2.3 Legal or General Justice

The third dimension, which is traditionally called legal or general justice, is closely related to distribute justice and can be seen as the other side of the same coin. It covers the members' relations to the social whole, and one of its principal manifestations is respecting the legitimate laws and authorities of a community.

General justice is necessary for peaceful and stable society, while lack of justice leads to crime in various forms. The social and economic implications of this form of justice are evident, as they include by the welfare loss caused by criminal activity and also the costs of crime-prevention activity.

3.3.3 Fortitude

The remaining cardinal virtues – fortitude and temperance – are relevant both indirectly (in relation to prudence and justice) and directly. The principle of the unity of virtue implies that fortitude and temperance play a *support function* for prudence and justice, because cowardice, impatience, indulgence, greed and other forms of vice are the usual causes of poor judgment and mistreatment of others.[30]

[30] An interesting case that illustrates the effects of moral virtues on judgment and prudence is the legendary investor Warren Buffett. There have been no systematic studies on Buffett's moral character, but he has on many occasions emphasized the importance of courage and patience for value investing, because one's judgment is not vindicated overnight and one must remain faithful to one's investment strategy even when it does not work immediately (see Hagstrom, 2005: 163, 179-181; Schroeder, 2008). In his own words, "We don't have to be smarter than the rest; we have to be more disciplined than the rest" (quoted in Hagstrom, 2005: 180). Buffett also once said: "Investing is not complicated; you work to find pockets of value. You didn't need a high IQ to buy junk bonds in 2002 – you needed to have the courage of your convictions when everyone else was terrified, and it was the same in 1974. People were paralyzed. You need to learn to follow logic rather than emotion, and that's easier for some people to do than others." (Casterline, 2006). In terms of the unity of

Fortitude may not seem to relate to economics (it is more likely to make one think of war), but in fact this virtue has several positive economic implications. I would like to mention two of them. One is *industriousness*, which is fundamental for economic growth. The attitudes that people have towards hard work is an important determinant of actual labor market dynamics and social costs of different welfare policies (see Lindbeck and Nyberg, 2006; Lindbeck, Nyberg and Weibull, 1999). Other implications of fortitude include the *courage* to take risks and *perseverance* in the face of difficulties and obstacles, which are important determinants of successful entrepreneurship (see Sirico, 2001).

3.3.4 Temperance

Temperance, too, is necessary for prudence and justice, and it is easy to imagine different ways in which lack of temperance leads to injustice. For example, greed and avarice (inordinate love for money) lead to criminal activities as well as a range of principal-agent problems, which cause significant economic costs and often cannot be entirely eliminated through formal mechanisms. As the old wisdom has it, *radix malorum est cupiditas*, "love of money is the root of all evil" (1 Timothy 6:10; contrary to a common misquotation, the text does not say that "money is the root of all evil").

Temperance is also necessary for economic efficiency, because it helps to direct limited economic resources to their most important uses, and supports a culture of saving and investing, which is necessary for both personal and macroeconomic financial stability as well as long-term economic growth. In contrast, intemperance leads to various kinds of direct economic costs. Gregg (2008) makes the interesting argument that the decline of temperance was an important contributor to the 2008-09 financial crisis:

> "The thrifty, even parsimonious Adam Smith would have been appalled by the 'I-want-it-all-now' mentality that has helped the personal savings-rate in America to hover around 0 percent since 2005 – the lowest rate since the Depression years of 1932 and 1933. It is arguable that the same mindset encouraged many on 'Wall Street', anxious to enhance their bonus prospects, to sell securities they knew were based on collapsing subprime foundations to 'Main Street' buyers who themselves were blinded by the prospects of quick profits."

Intemperance causes numerous other costs as well, including the costs of addiction to drugs, alcohol or tobacco.

---

virtues, it is interesting to note that the "Oracle of Omaha" is also famous for his frugal personal lifestyle and generous charitable donations (Schroeder, 2008: 487-488).

4 LAW AND VIRTUE: TOWARDS AN ECONOMIC ANALYSIS

This part of the essay applies the virtue-based theory of behavior to economic analysis of law. There are two levels of analysis. One is labeled *"static" analysis*, which assumes a fixed "level of virtue" (or, putting it differently, "level of vice"). In other words, this type of analysis views virtue as an *exogenous* variable (an independent variable not affected by the model). It could also be called *short-term* analysis: although the relevant time period cannot be determined precisely, one feature of classical virtue theory is that the character of people does not change overnight, so that the shorter the time period in consideration, the more stable (and, hence, exogenous) the "level of virtue" is likely to be.

The second level of analysis is to introduce variations of the level of virtue or vice by way of feedback to the adoption of legal rules. This *"dynamic" analysis* focuses on the role of law in safeguarding and promoting virtue. In other words, it treats virtue as an *endogenous* variable (a variable whose value is affected by one of the functional relationships of the model). It could also be called *long-term* analysis, because moral character may change over time.

Given the complexity of the topic as well as the scarcity of previous studies, the discussion is more of an impressionistic sketch rather than a robust model. It is intended to provide a basis for further, more detailed studies.

4.1 Three Types of Economic Analysis of Law

Economic analysis of law can mean a number of things, so a small clarification is in order. Ogus (2004: 383-385) makes a helpful distinction between three types of economic analysis of law: (a) *positive law and economics*, which is "the application of economic methodology to predict the impact of law and legal institutions on behavior" (p. 384); (b) *normative law and economics*, which gives guidelines for the improvement of law and legal institutions, following the criterion of allocative efficiency; and (c) *"interpretive" or "explanatory" law and economics*, which examines the prediction that the law – in particular, the common law – has an economic function, i.e. that many legal rules can be interpreted as promoting allocative efficiency even if economic terminology is not used. This last type of analysis is what Richard Posner has, somewhat confusingly, called "positive law and economics" (see Posner, 1979, and Landes and Posner, 1981).

This helpful categorization can be applied to the present topic, i.e. virtue-based economic analysis of law, to highlight the intended contribution of this perspective to standard law and economics. Firstly, in terms of *positive* analysis, the claim is that the virtue perspective gives us a better understand of why certain legal and institutional arrangements yield certain economic (and other) outcomes. In other words, presence or lack of certain virtues is one of the factors to be taken into account in trying to predict the impact of law and legal institutions on behavior.

Secondly, *normative* analysis looks for the optimal design of law and institutions, but in this case, the virtue perspective also provides additional criteria other than allocative efficiency; for example, it may be argued that law should also promote the acquisition of moral virtues by citizens. In practice, as will be seen later, normative analysis generally presupposes some positive analysis, because prescription depends on description.

Thirdly, *"interpretive" or "explanatory"* analysis is an attempt to understand existing legal rules. In Posnerian law and economics, the prediction is that the law reflects considerations of economic efficiency. From the virtue perspective, an alternative hypothesis may be formulated: namely, that existing laws also reflect the desire to promote the virtues, and that sometimes they do this in opposition to what economic theory would advocate following the criterion of allocative efficiency. If and when this hypothesis is correct, laws which seem to be at odds with standard economic theory may appear reasonable from a virtue perspective.

In the following sections, all three types of economic analysis are employed, using the virtue perspective. The emphasis is on normative analysis, which however is intertwined with positive analysis, so that the latter cannot be entirely neglected. In specific places, interpretive or explanatory analysis is also introduced.

4.2 Static Analysis: Optimal Law with a Fixed Level of Virtue

The key idea of this section is the optimal design of law will depend on the extent to which people possess certain virtues. Already Isidore of Seville[31] in his *Etymologiae* argued that, in order to serve the common good, law must be made "according to the customs of the country" and "adapted to place and time."[32] In the following discussion, the complex reality of possession or non-possession of virtues by the citizenry is denoted with the simplifying term *level of virtue(s)*.

The following sections look at the issue with respect to six dimensions of legal design: (1) the amount of freedom, or alternatively, the extent of legal constraints on choice; (2) the demands of law, i.e. the extent to which law demands virtuous behavior of the citizens; (3) the precision of legal commands, (4) the choice between narrow rules and broad standards; (5) the type of sanctions used to enforce the law; and (6) the process and locus of law-making and law-enforcement, especially with respect to participation by different individuals and groups.

In this analysis, I will first make some simplifying assumptions, such as *perfect knowledge* of the level of virtue, *homogeneity* of citizens in terms of virtue, *well-meaning law-makers*, and the absence of other social control mechanisms. In later sections, I will relax those assumptions to see how the analysis if affected.

---

[31] Bishop of Seville, died 636; an important theologian and "Father of the Church."

[32] Cited by Aquinas (1920: I–II, 96, 2; 95, 3).

4.2.1 Virtue and Freedom (Legal Constraints)

With respect to freedom and virtue, there is a famous statement by Edmund Burke:

> "Men are qualified for civil liberty, in exact proportion to their disposition to put moral chains upon their own appetites; in proportion as their love to justice is above their rapacity; in proportion as their soundness and sobriety of understanding is above their vanity and presumption; in proportion as they are more disposed to listen to the counsels of the wise and good, in preference to the flattery of knaves. Society cannot exist, unless a controlling power upon will and appetite be placed somewhere, and the less of it there is within, the more there must be without. It is ordained in the eternal constitution of things, that men of intemperate minds cannot be free. Their passions forge their fetters." (Burke, 1791: 68-69)

Burke's claim is intuitively correct in light of classical virtue theory. When people are virtuous, they will tend to act wisely, justly, temperately etc. When that is the case, there is relatively little need for the law to interfere.

This does not necessarily mean that there need be no law at all, even if it were the case that all the citizens possess all the virtues to the extreme. Following a classical distinction, law may be divided into two principal categories: (a) *law as coordinator* and (b) *law as educator* (see Gregg, 2003: 59-62). For example, most traffic rules – such as whether one is to drive on the left or the right, and most kinds of speed limits – serve a merely coordinating function, helping members of society orientate their activities in a more harmonious fashion. In contrast, criminal law serves a more educational function, trying to impose limits and deterrents on immoral behavior and protecting other members of society from unjust harm. The educational role of law is principally to provide negative incentives, but not solely, because laws also have an important expressive function, which has a bearing on collective notions of moral right and wrong (Sunstein, 1996).

Most areas of law contain both coordinating and educational elements. The principal idea for present purposes is that if people were infinitely virtuous, the educational role of law would become unnecessary; and the extent to which people lack certain virtuous, the educational function gains in importance. On the other hand, the coordinating role would remain, although even that would presumably become less important, given that prudent persons are more capable than vicious persons of finding just and harmonious solutions to coordination difficulties on a voluntary basis.

The first principle may then be formulated as follows: *Virtue goes together with more freedom (and fewer legal constraints); lack of virtue calls for more legal constraints (less freedom).*

If we try to relate this principle to the existing literature on the economics of institutions, one way of understanding it is to refer to the distinction between *external and internal constraints* (see Panther, 2000). Taking it is given that some constraints must be placed on choice if people are to live and act in harmony, it follows that a tradeoff exists between external and internal constraints: when there are significant internal constraints, external constraints become less important; and vice versa. Law is one type of external constraint (although not at all the only type), and virtue might be classified as a kind of internal constraint. It should, however, be borne in mind that virtue seems to imply some internal constraints on action, it cannot without difficulty be *identified* with such constraints: virtues are also *a type of freedom*, because virtues as such do not "impose limits", but rather they are *enabling* characteristics of acting persons. In a sense, it is vices that impose limits on choice, making it more difficult to choose well; that this is so becomes obvious when one considers cases of pathological intemperance, such as drug addiction: overcoming such an addiction is subjectively speaking a *liberating* experience, not a constraining one.

Here are some further examples to illustrate the principle. It may be said there are two different types of constraint that may be needed if people lack virtue. One type of constraint is those which *protect others* from unjust harm. In this respect, the principal virtue that is lacking is *justice*. When people are prone to treat others unjustly, their actions must be constrained externally, at least to some extent.

In terms of law, the most important area with respect to lack of justice is *criminal law*, the main purpose of which is to protect others from unjust harm. But the principle can be applied to others areas of law too, including *contract law*. If people are highly virtuous, the law can leave them free to make all kinds of contracts, whereas more regulation and protective measures will be needed if some or all people are inclined to deal dishonestly, deceitfully or unscrupulously with others. On the other hand, lack of virtue may also advice against very complicated and demanding legal norms, as will be explained later. Many other examples could be given: in *constitutional law*, more limits need to be imposed on public authorities if they are inclined to abuse their power, whereas the politicians and civil servants of a highly virtuous society can be entrusted with more discretionary powers; in *regulatory law*, more regulation is needed if people do not freely act justly and taking into account the common good; and so on.

The second type of constraint is those which *protect the actor from his or her own weaknesses*. Here, the principal virtue that is lacking is the cardinal virtue of *prudence*: experience, objectivity, and the ability to choose the best option for

oneself. Of course, other virtues such as intemperance and lack of fortitude may also be present (consider, again, the case of addictions).

Law may, and indeed does, respond to the lack of prudence in various ways. In the field of contracts, for example, *consumer protection laws* seek to defend apparently weaker and less skilful parties from entering into unfavorable contracts. Some aspects of consumer protection are justified on the basis of "inequality of bargaining power," but sometimes "courts do intervene in cases where a 'poor and ignorant' or otherwise disadvantaged person has entered a contract on manifestly one-sided terms" (Dnes, 1996: 73). Some aspects of the general provisions on contractual validity can also be explained using the assumption of lack of prudence: the very young, and others who lack the full use of their reason, cannot enter into contracts other than very minor ones. This does not mean that restrictions on contracting are always a good idea, even if the actors lack prudence: these restrictions impose costs, sometimes they are ineffective, and protective regimes may have a negative effect on character development, as discussed later in the dynamic analysis.

Many types of *regulatory law* also protect individuals from their own foolishness. One example is the regulation of the market for *drugs, alcohol, tobacco and other substances or activities* which may harm the consumers themselves and, furthermore, impose negative externalities on others. The optimal level of restrictions depends on the aptitudes of the people: for example, in Nordic and other colder countries there seems to be a greater tendency to overdrinking, and the law responds by imposing higher taxes, more limits to advertising alcohol, and harsher penalties for drunk-driving.

Advertising regulation generally is a way of limiting the potentially negative effects on consumer choices of the overabundance of invitations to consume. For example, restrictions on, and compulsory disclosures of, product placements in movies can be seen as an attempt to make people more aware of the advertising intent and thereby enhance the exercise of prudence on the part of the viewers. In terms of the virtue of prudence, advertising to children is particularly problematic, because children have less developed abilities of rational discernment.

4.2.2 Virtue and the Demands of Law

In a classic text, Aquinas (1920: I–II, 96, 2) asks "whether it belongs to human law to repress all vices?" And he answers in the negative, not because he thinks some vices are good for anyone, but because the "possibility or faculty of action is due to an interior habit or disposition: since the same thing is not possible to one who has not a virtuous habit, as is possible to one who has." Therefore,

> "many things are permissible to men not perfect in virtue, which would be intolerable in a virtuous man. Now human law is framed for a number of human beings, the majority of whom are not perfect in virtue.

> Wherefore human laws do not forbid all vices, from which the virtuous abstain, but only the more grievous vices, from which it is possible for the majority to abstain; and chiefly those that are to the hurt of others, without the prohibition of which human society could not be maintained: thus human law prohibits murder, theft and such like."

Now, Aquinas's response raises another set of issues, that is, what law should do about the fact that some people are more virtuous than others; that will be discussed later in detail. For the present, let us focus on the narrower question of how demanding the law should be – assuming, for simplicity, that the level of virtue is more or less homogeneous among the citizens.

Following Aquinas, we may formulate the second principle: *Virtue goes together with more demanding law; lack of virtue calls for less demanding law*. The reasoning is simple. If the law strictly prohibits everything that falls short of absolute perfection, then law becomes oppressive, expensive to enforce, and ultimately unhelpful for the development of virtue, because it leaves no scope for genuinely free choice. On the other hand, the absence of any legal constraints will tend toward the law of the jungle if people are not highly virtuous.

This second principle could be restated by saying that *law cannot demand more than the subjects are able to give or bear*. Thus it is a kind of philosophical interpretation of the ancient Roman legal principle, *nemo dat quod non habet*: no one gives what he does not have.

The dilemma faced by law-makers with less-than-virtuous citizens can be understood as an instance of *toleration* in the proper sense of that word. Toleration does not mean respect or moral acceptance of the beliefs or actions of others; rather, it "refers to the conditional acceptance of or non-interference with beliefs, actions or practices that one *considers to be wrong* but still 'tolerable', such that they should not be prohibited or constrained" (Forst, 2007, emphasis added). One of the principal motives for tolerating moral wrongs is that greater evil would result from trying to prohibit the beliefs or actions in question.

This idea is closely related to that discovered by Gary Becker in his seminal article on the economic approach to crime and punishment (Becker, 1968). He demonstrated the counter-intuitive principle that, when criminal activity is economically attractive and the costs of apprehension and conviction are significant, the *socially optimal level of crime is positive*, not zero. Of course, Becker focused solely on economic costs, while there are also other, including moral costs. The principal difference in the virtue-based approach is to include variation in the *supply of crime*, because that depends not only on the economic benefits of criminal activity, but also on the virtues and vices of the people.

A classic example of the mistake of imposing too demanding constraints is *prohibition laws*, which sought to do away with the problem of alcohol through its legal prohibition. The intent was presumably laudable, but the effects were problematic, because the attraction of alcohol was so strong and drinking so

widespread that enforcing the law became impracticable. Further, the illegality of the highly profitable alcohol trade fostered criminal activity. On the other hand, it has been argued by revisionist researchers that the prohibition was successful in some respects: the principal mistake was to impose too sudden and drastic changes, and to dedicate too scarce resources to enforcing the laws (see Blocker, 2006).

This second principle is especially interesting in light of the previous question concerning freedom and virtue, because it turns out that, if Aquinas's classic response is correct, a tension emerges: if earlier virtue was connected with freedom (fewer constraints), now it seems that virtue implies that law can be more demanding, while vice implies that law needs to tolerate more foolishness and injustice. This tension does not imply outright contradiction, because it is also a question of what kinds of constraints are imposed. Thus, in a "society of saints", the law can allow more freedom, but it can also perform more detailed coordinating and pedagogical roles, for example by providing more abstract principles of fairness and equity, because the citizens are able and willing to follow the directions of the law. In contrast, a "society of knaves" needs strict rules on fundamental justice, leaving people less discretion in terms of how to conduct their affairs, but the law will refrain from giving too detailed rules or guidance. In the case of the first principle, the question was whether it is *necessary* to impose certain legal constraints; in the second principle, it is whether it is *advisable* to impose them, given that greater evil may result if the law demands too much.

4.2.3 Virtue and Legal Precision

The second principle is closely related to a third dimension, namely the notion of the *precision of law*, i.e. "the degree of detail or differentiation involved" (Kaplow, 2000: 503). The general theory in economic analysis of law is that more precise rules are better in principle, but their downside is that they generate higher formulation, adjudication and information costs. Legal precision is also a major source of *legal complexity*, which is usually seen as something to be avoided.

The question would merit a detailed treatment, but in simple terms, we may formulate the third principle as follows: *virtue goes together with more precise laws; lack of virtue implies less legal precision*. The reason is again quite obvious when one considers the fact that the various costs generated by more precise rules are systematically affected by virtue and vice: higher level of virtue implies lower formulation, adjudication and information costs, and vice versa.

For example, if people are very prudent, that is, they are capable of making wise decision, it follows that they are better equipped (as law-makers) to formulate good, more precise rules, and similarly they are better equipped (as adjudicators) to interpret and apply those precise rules in concrete cases. Furthermore, if people practice justice freely, they will live in greater harmony

and will have fewer disputes; this implies that the law will be invoked less frequently, and both adjudication and information costs will be reduced as a result. In contrast, lack of virtue will produce the opposite effects: the quality of law-making and adjudication will be lower, resulting in precise rules of a lower quality and, in all likelihood, contradictory complexity; further, a higher frequency of legal disputes will increase the costs of settling disputes within a complex legal framework.

This principle can also be used as an interpretive tool in legal history. Over time, legal systems have become increasingly precise – and complex. While there may be reason to criticize this trend, it may also be argued in light of the virtue perspective that the widening and deepening of education (which is closely linked to some virtues, especially prudence) has rendered legal systems better equipped to making well-specified demands and handling the resulting complexity.

It might be felt that it is wrong to conclude that more virtue implies that the law should be more complex; after all, it was said earlier that if the level of virtue is high, law-makers may issue more abstract commands of justice and fairness. There is no contradiction, however, because more abstract norms do result in more complex rules when applied in practice. This question is discussed next in detail.

4.2.4 Virtue and Rules vs. Standards

The tension between the first three questions is better understood when we consider another dimension of legal design, namely the choice between narrow rules and broad standards. In law as well as in other fields of thought, a balance must often be struck between concreteness and abstraction. Overly narrow rules leave no scope for improvisation, and the classical virtue approach is skeptical of attempts to specify beforehand the right solution to every possible case (see Pieper, 1966: 25-28). On the other hand, too broad standards are not helpful for those whose sense of prudence, justice and so on is less developed. *In extremis*, all norms could be reduced to a primary moral norm such as "do good and avoid evil", but it would fail to provide sufficient guidance for most of us when we are faced with the complexities of life.

If this is true in abstract thought, then even more in legal practice. Law is a crude and imperfect instrument, and narrow rules will tend to be either *under-inclusive* (failing to regulate activities that should be regulated) or *over-inclusive* (regulating activities that need not be regulated). Broad standards, on the other hand, give rise to *interpretation costs* and may also be *poorly enforced* in practice. In economic analysis of law, there is a rich literature discussing the problem (see Kaplow, 1992, 2000; Schäfer, 2002; Schlag, 1985).

In the relation to the concern raised towards the end of the previous section, Kaplow (2000: 508-511) points out that, in principle, *both rules and standards can be precise and complex*. The fundamental difference is that *narrow rules* provide

greater specification in advance (resulting in higher formulation costs), while *broad standards* have to be specified in concrete cases (resulting in higher adjudication costs). In light of the informational difficulties of formulating accurate rules, broader standards may seem to be better, but in practice, standards are often poorly applied to concrete cases (for example in negligence disputes in tort law), so that the precision of the law is diminished. The optimal choice between rules and standards depends on a range of factors; as a general principle, "rules tend to be preferable when particular activities are frequent, and standards do best when behavior varies so greatly that any particular scenario is relatively rare" (Kaplow, 2000: 510).

What the virtue perspective implies for this dimension of legal design is not entirely clear. Extending the discussion of the previous section, we may say that a higher level of virtue will, on the one hand, mean a better quality of narrow rules, but on the other hand, it also implies a better application of broad standards and lower adjudication and information costs. Despite this ambiguity, it is likely that *virtue goes together with broad standards (principles-based law); lack of virtues calls for narrower rules.*

This principle seems unavoidable when one considers the extreme cases. In a "society of saints", few specific rules would be needed, because all behavior would be governed by the requirements of general justice – which, by definition, perfectly prudent citizens would know how to apply to all the different circumstances. And, indeed, what general justice requires is much broader and more demanding than what ordinary legal orders require. In fact, a perfectly virtuous person only needs to follow the so-called first precept of morality: "do good, avoid evil". Thus in such a society, few resources need to be dedicated to law-making and law-enforcement. In contrast, a "society of knaves" needs narrower rules, because its citizens are not well-equipped to interpreting broad standards, either as private person or in public capacity.

An example serves to illustrate the matter. In *contract law*, a higher level of virtue implies that the law may focus on enforcing and demanding broad principles of fairness, good faith and so on; in fact, these will be followed freely by highly virtuous citizens. When the level of virtue is low, in contrast, the law will need to provide clearer guidelines and stricter rules. Naturally, in the latter case it should be borne in mind that broad standards may still be optimal when particular scenarios are rare, because this helps to avoid unnecessary law-formulation costs.

In financial markets regulation, there is a debate concerning *principles-based regulation*, especially as practiced in the UK (see Black, 2010; Ford, 2010; FSA, 2007, 2009). Financial firms have generally favored this approach, as it has been felt that it generates lower compliance costs. This belief is not necessarily true if the enforcement regime is severe, however, because broader standards imply more uncertainty of application (Schwarcz, 2009). In light of virtue theory, on the other hand, one may argue that principles-based financial regulation should

also take into account the level of virtuous disposition among the regulated parties, that is, financial firms.

The question of legal design is greatly influenced by the virtues and vices of *public officials*. The principle formulated earlier implies that broad standards are more advisable and workable when those applying them are virtuous, whereas narrower rules may be better if their level of virtue is low. This is consistent with the findings of other authors: for example, Sunstein (1995) has pointed out that broad standards give more *discretionary power* to judges and officials, and this may be problematic if they are prone to prejudice and other types of injustice.

Hans-Bernd Schäfer (2002) has also indicated that if politicians are prone to corruption, it may be better to entrust law-formulation to independent courts – as in the traditional common law system – because courts cannot be easily influenced by special interest groups (Schäfer, 2002: 4-5). This is supported by the fact that the judge-made common law system was traditionally quite free from rules favoring interest groups, and it was therefore more favorable to free market principles. On the other hand, a legal system that relies heavily on broad standards may fail to function well when transplanted into a lesser developed country if the judiciary of the latter is poorly trained (lack of prudence) and also prone to corruption (lack of justice).

4.2.5 Virtue and Legal Sanctions

Another important factor is the type of legal enforcement (sanctions). It is one thing that the law demands certain kinds of conduct, but it is a separate question what happens if the demands of the law are not fulfilled. The variety of possible sanctions is very high, even when non-legal sanctions are excluded, but for simplicity, we can work with an abstract scale of sanctions, ranging from very harsh to no penalties for rule-infringement.

The question of sanctions is closely related to the previous point on legal demands, because, if the punishments are too severe (imagine that the minutest violation of the most insignificant traffic rule leads to the death penalty), then the entire system will tend to break down and become unmanageable for the sheer cost of enforcing the law. On the other hand, the complete absence of any kind of penalties whatsoever would render the law practically meaningless, at least in terms of external incentives.

Considering again the theoretical extremes of very high and very low level of virtue, we may formulate the fifth principle: *virtue goes together with lighter enforcement/sanctions; lack of virtue calls for harsher punishments for rule-infringement.* This follows from the fact that highly virtuous citizens need law principally for guidance and mutual coordination, and they will fulfill the just demands of the law freely, simply because it is the right thing to do. In contrast, brutish men will not easily follow such advice and need strong external incentives to abstain from foolish and unjust activity.

One specific example to consider is the so-called *"comply or explain"* model of regulation, which is used in many countries (including the UK, Germany and Finland) in the field of corporate governance. It is a form of *soft regulation*, providing a standard approach which however is not binding; but if it is not followed, an explanation must be publicized. "Comply or explain" provides flexibility and therefore may be the most efficient model when the financial stakes are not significant and when there is a sufficient level of virtue among the relevant actors. On the other hand, it may work poorly if the regulatees are unwilling to comply without clear sanctions (see generally Andres and Theissen, 2008; Arcot, Bruno and Faure-Grimaud, 2010).

Partnoy (2003) argues through several case studies that in the US regulation of financial markets, there has been a general failure to impose convincing penalties on individuals who seriously break the rules and inflict significant damage on others. One problem is that prosecuting complex financial fraud is terribly difficult. The other is that most of the actual penalties were a mere "slap on the wrist" in comparison with the profits, so that the resulting expected cost of penalty was very small, given very low probabilities of getting caught.

The fifth principle could also be used as an interpretive tool in legal history. As a general trend, legal systems have become less severe over time: punishments for criminal activity have become more humane, and groups such as debtors have come to be treated with more understanding and forgiveness (for example, debtors' prisons have been abolished). The causes of this evolution are inevitable complex. As an initial hypothesis, one might present a virtue-based perspective: factors such as wider general education have enabled more people becoming *civilized*, and hence the nature of optimal punishments has also changed. Obviously, this hypothesis is only understood as a partial explanation. Moreover, one should not merely presume that the design of the law is always optimal, whether today or in the past.

The fifth principle is again in tension with the second one: earlier, it was argued that lack of virtue calls for more tolerant law, but now it is claimed that it demands harsher punishments. This tension is important, because it highlights the fact that the specific design aspect of law should not be considered in isolation; it is their totality that matters.

4.2.6 Virtue and the Making and Enforcement of Law

We have already made various allusions to the task of making and enforcing laws, but this may also be considered as a separate dimension of legal design. The relevance of virtues – of *prudence and justice* in particular – is perhaps especially obvious in this context, because making good laws that serve the community well and applying them fairly and correct to concrete cases are activities that require plenty of experience, sound judgment, fairness, impartiality, and similar qualities. People who lack prudence and justice are quite clearly not fit to govern the society (and, indeed, they are only imperfectly

fit to govern themselves). This simple insight can be translated into the sixth principle: *Virtue goes together with more participation in law-making and law-enforcement; lack of virtue implies less participation.*

This principle coincides with the classical idea in political theory that the functioning of democratic government requires a certain level of education, culture and virtue (see Aristotle's *Politics*, 1988: III, 11). Of course, there are numerous variations of democratic governance, so one could say that, in light of virtue theory, a higher level of virtue speaks in favor of more direct and complete participation, including popular referenda, while a lower level of virtue seems to imply that indirect (parliamentary) democracy is preferable, and in some cases democracy might not be a good idea at all.

The same principle could be used in an interpretive way to explain the fact that children cannot vote. It is a rough rule, which may be both over-inclusive and under-inclusive in terms of the level of virtue, but it is nevertheless a sensible rule of thumb to say that persons below a certain age have not developed a good capacity for judging complex matters of social life. Sometimes one hears demands for the setting up of a minimum education level for the right to vote; that may seem to correspond to the demands of virtue theory, but in practice it would be problematic for a range of reasons, and probably it, too, would be both over-inclusive and under-inclusive, because some people are highly virtuous without being formally educated, while others are not virtuous at all despite all their education.

Apart from the question of democracy, the sixth principle can be extended in numerous ways. As an example, *self-regulatory regimes* may be the ideal solution when the relevant individuals have a high level of virtue and are willing to deal justly with others (on self-regulation, see generally Ogus, 2000). In contrast, self-regulation may be a poor idea if the people in question lack certain virtues, because self-regulatory regimes are easily abused by unjust people.

In many fields of *private law*, there is also scope for a kind of self-made law. Contract law and the law of associations give persons significant power to make legally binding rules for themselves. In light of virtue theory, it is appropriate for virtuous persons to have more freedom to decide for themselves, including in the sphere of private law. In contrast, people with less virtue are less capable of governing themselves, and in the sphere of private law also they need – and benefit from having – more constraints on their choices (assuming, of course, that those constraints are well designed and genuinely helpful). Thus, again, the virtue perspective accounts for the limited legal capacity of infants, minors and other persons under special conditions.

4.3 Some Difficulties and Responses

There are at least two difficulties in designing an optimal legal regime that takes into account the virtuousness of citizens. One problem is that we lack information concerning the possession or non-possession of virtues. The second

difficulty is that, in any given society, people are different and it may be impossible to talk about a unified level of virtue. The following two sections discuss some possible responses to these concerns.

4.3.1 Lack of Information

The first major difficulty is that we do not have accurate information on the level of virtue. In fact, virtues are not easily amenable to measurement, and even in our personal case, it can sometimes be difficult to determine to what extent we possess or lack certain virtues.

This does not mean that the virtue approach must be abandoned. A useful analogy is provided by so-called *happiness studies* (see generally Bruni and Porta, 2006; Van Praag and Ferrer-i-Carbonell, 2007). The idea of measuring happiness may have appeared as absurd some time ago, but empirical methods have been developed to make at least some sense of variations in subjective well-being.

Arguably, the level of virtues could also be estimated empirically, especially with the help of suitable *proxy variables* (see Sison, 2003: 147-163). Writing in the context of management literature, Sison proposes that the moral capital of a company's workers may be estimated with such quantitative indicators as employee turnover rates, absenteeism, tardiness and the incidence of illegal activity (Sison, 2003: 150-151). Value-surveys and in-depth interviews may also be employed to obtain qualitative data on indicators as "quality of home-life, rest and leisure, involvement in volunteer work and community out-reach programs, religious observance, and so on" (Sison, 2003: 152).

For purposes of legal design, the focus is on the broader society; sub-groups may be relevant when it comes to targeted regulation. There are numerous possibilities for proxy measures of the level of virtue. Such factors as the *corruption perception index* and the general amount of *criminal activity* give a rough sense of the level of justice, while the general level of *education* provides a basic idea of the level of prudence among citizens. Looking at specific virtues, one can go into greater detail and differentiation; for example, *alcohol and drug abuse* is principally related to intemperance, where *white-collar crime* is more linked to dishonesty and avarice. Ideally, specialized measurement techniques should be developed to gather more accurate and reliable data. Over time, such data would become useful for purpose of making better laws.

When it is a question of active regulation, it is possible to design the regulatory strategy in such a way that it takes into account the variation of the level of virtue, and our limited knowledge thereof. Ayres and Braithwaite (1992) have outlined a range of approaches that resonate well with the virtue perspective presented here. One of them is called the *benign big gun approach*. That approach to regulation acknowledges the fact that many regulatees are motivated to do the right thing and treat others justly, but there is always the danger of more exploitative actors. Both types should be treated differently, if

optimal results are to be attained: the former need guidance and persuasion, while the latter need the threat of strong punishments.

When the regulators do not know the motivational base of the regulatees, they can mitigate the problem through *pyramid strategies of responsive regulation* (Ayres and Braithwaite, 1992: 35-41). In one variant, there may be a scale of rapidly escalating sanctions if rules are repeatedly violated; the sanctions would become systematically severer: (1) persuasion – (2) warning – (3) civil penalty – (4) criminal penalty – (5) license suspension – (6) shutdown or license revocation. Another variant focuses on the type of regulation, and it is relevant when the regulated industry is quite homogeneous but the legislator does not know its motivational base (or level of virtue); the regulatory strategy would become more restrictive if abuses are observed: (a) self-regulation – (b) enforced self-regulation – (c) command regulation with discretionary punishment – (d) command regulation with nondiscretionary punishment. In the second variant, changes would have to be executed by the government through legislation. According to the authors, it is however fundamental that the pyramid strategy is communicated in advance in a clear and credible manner, and that the escalation is executed rapidly so that credibility is not lost. Note that in the proposals of Ayres and Braithwaite, the change of enforcement approach corresponds to the principles outlined in this essay, either through tougher sanctions (fifth principle) or more participation in rule-making (sixth principle).

4.3.2 Heterogeneity: Legal Responses

The other difficulty is that people are different. The level of virtue in any given society will vary significantly from person and community to another. Yet the law must, at least ordinarily, treat all people equally. However, this does not mean that the virtue perspective is useless; it turns out under closer examination that even when the rules are formally the same for everyone, it does not mean that everyone is treated the same way in fact. Here are five reasons why.

Firstly, the law can sometimes *treat people differently*. For example, a person who has been convicted of a crime will often receive more stringent treatment. The common policy that repeat offenders usually get harsher penalties than first-timers is *explained and supported by the virtue approach*: one might commit a crime out of drunkenness or external pressure, but the fact of continuing to commit further crimes is a strong indication that the person in question has a serious character problem, and the law is justified in adopting severer measures in response.[33] There may also be differential treatment in the process of criminal investigation. This type of "legal discrimination" of criminal persons seems to be supported by virtue theory: people rarely change overnight (if at all), and it is

[33] Dal Bó and Terviö (2008) also find that harsher penalties for repeat offenders are justified under their model.

reasonable – and economically efficient – that the law views certain persons with more suspicion or severity, given their past behavior.

Secondly, law may sometimes be designed so that it only applies to *specific groups of people*. A particular law may be designed to address conduct that in itself implies something about the actor's level of virtue. In economic terms, this resembles the notion of *adverse selection*. In criminal law, for example, this happens explicitly because criminal acts are contrary to the virtue of justice (assuming, of course, that the law itself is just); therefore, the law does well to treat present or past criminals with some more suspicion.

There may also be *implicit adverse selection*: one example is so-called instant loans, which are generally used only by people who lack personal finance skills and hence are likely to lack prudence; therefore the market for instant loans may justifiably be regulated more than that of other types of credit. In the other extreme, one can consider the market for private placements, which is de facto only accessible for those with significant wealth; that market does not require so much regulation, because the fact that someone is wealthy normally implies that he knows how to take care of financial affairs (perhaps with some exceptions such as those who inherited their wealth).

More generally, some areas of law are *targeted to specific activities*, which in themselves do not imply anything specific about the level of virtue, but still the people in question will be more homogeneous than the society at large. One example is *industrial regulation*. Different industries tend to have different cultures and to attract people with certain backgrounds, interest and values. Moreover, some industries entail specific threats to the practice of virtue – one thinks of the vice of greed, present in financial markets in a special way – and it may be appropriate for law-makers to take that into consideration.

Thirdly, some legal rules only apply to *individuals who have certain qualities*, such as education or experience. For example, some rules imply restrictions based on proxy measures related to the virtue of prudence. In financial regulation in the more distant past, access to markets was limited in various ways, such as knowing the right people, and thus there was plenty of *de facto access control*. Today, those markets are more widely accessible, but there are rules – explained by the virtue perspective – that limit the application of certain rules depending on client categorization; as a rule, non-professional clients are awarded more regulatory protection. In many markets, certain riskier activities such as options trading are also restricted to clients who have a specified numbers of years of experience as investors.

Fourthly, some rules *control entry to special social roles*. In light of virtue theory, this may be seen as a way of simplifying the task of regulating the people in charge of those social responsibilities that call for a higher level of virtue. The punishment for certain crimes is simply the exclusion (perhaps for a period of time) from participating in some markets or other social activities. For example, financial crime may be punished by excluding the person from working in the

financial sector for a specific number of years, and persons guilty of company-related fraud may be disqualified from starting new businesses or exercising positions of responsibility in other companies.

More generally, the imprisonment of serious criminals is effectively a way of excluding them from participating in almost any kind of social life. In addition, the fact of having a criminal record may an impediment to entering certain professions or positions of authority. These kinds of *negative entry criteria* ("no criminal record") can be interpreted as attempts to bar individuals with demonstrably bad personality traits from social positions in which greater power is exercised and the virtue of justice is especially important. For example, sexual offenders cannot, or should not, work with children.

The law may also impose *positive entry criteria*. For example, the establishment of a financial services company in many countries requires that the board members are carefully scrutinized to ensure their trustworthiness, fitness and professional competence. The financial services industry creates many opportunities for highly profitable fraud, and entry control is a way of limiting access to important position to persons who are less likely to engage in fraud.

Fifthly, as a broader policy issue, the virtue perspective may be seen as an argument in favor of a certain degree of *social homogeneity*. To put it differently, highly multi-cultural societies will run the risk of finding it more difficult to design efficient legal regimes, given that different cultures tend to emphasize and foster some virtues and neglect others. On the other hand, cultural exchange and variation may be beneficial for the development of virtue, so determining the optimal balance would require an extensive study. At any event, the point here is not compare the goodness or badness of different cultures, but to highlight the fact that different cultures may call for differing approaches to law, and it is easier to design suitable laws when they apply to a limited number of cultures.

As a corollary of the previous point, the virtue perspective may be seen as an argument for *decentralized law*. Decentralization implies that the law will be applied to a relatively more homogeneous community, whereas increasing legal centralization will make it more difficult to address the characteristics of all the people affected. European Union legislation is a much-discussed case in point: given the highly different cultural traditions of EU member states, one-size-fits-all legislation rarely functions well in all the countries, because – among other things – their cultures emphasize and foster rather different virtues.

4.4 Dynamic Analysis: Safeguarding and Promoting Virtue

In the static analysis, law-making has to take the level of virtue into account, because the virtues and the vices of citizens influence the real outcomes and consequences of laws. In the dynamic analysis, law influences the level of virtue

itself. In other words, virtues are not taken as a given, but they become an endogenous variable.

In terms of normative analysis, the starting point here is that virtues are something to be pursued – a normative objective – for two reasons. One reason is that virtue is a *social good* which, as explained earlier, gives rise to various *positive externalities*. The other reason is that, according to the classical theory, virtue is a *personal good*, an important determinant of personal well-being and a constituent aspect of a good life.[34]

The argument develops as follows. The first section below discusses some of the ways in which law helps to safeguard and promote virtue. However, there are limits to the extent to which law is able to accomplish this, and the second section argues that law may sometimes have a negative effect on the virtues of citizens. The third section highlights other reasons why we should, in any case, be wary about giving law-makers too much power for the ostensible purpose of making men morally better. Finally, the role of factors other than law is briefly considered.

4.4.1 Law *and* Virtue: A Positive Effect

There is a long-standing tradition in social and moral philosophy which highlights the positive relationship between law and virtue. The chief proponent of this view is without doubt Aristotle, the most important developer of virtue theory in general. At the end of his *Nicomachean Ethics*, Aristotle (1980) mentions the need to undertake another project on political theory rather than ethics:

> "while [moral arguments] seem to have power to encourage and stimulate the generous-minded among our youth, and to make a character which is gently born, and a true lover of what is noble, ready to be possessed by virtue, they are not able to encourage the *many* to nobility and goodness." (*Nic. Eth.*, X, 9: 1179b)

The reason why moral argument is not sufficient to convince the multitudes is that "passion seems to yield not to argument but to force," and many people "do not by nature obey the sense of shame, but only fear, and do not abstain from bad acts because of their baseness but through fear of punishment" (ibid.). In other words, the *deterrent effect* of the law is necessary, because otherwise some people will simply follow their lowest instincts. Although one may dispute with Aristotle on the rather elitist tendencies of his view of the common man, it is beyond doubt that many people need something more than mere words.

---

[34] The use of law to promote *virtue as a personal good* raises important questions of legal philosophy. See George (1993) for an extensive discussion and defense against critics of the position advanced here. The promotion of virtue as a social good is philosophically less controversial, because it is the external effects of behavior that the law is primarily concerned with.

Another writer in the same tradition, Aquinas (1920) writes in his *Summa Theologica* that "man has a natural aptitude for virtue," but the development of this aptitude requires training, and for some people, words alone are not enough:

> "since some are found to be depraved, and prone to vice, and not easily amenable to words, it was necessary for such to be restrained from evil by force and fear, in order that, at least, they might desist from evil-doing, and leave others in peace, and that they themselves, by being habituated in this way, might be brought to do willingly what hitherto they did from fear, and thus become virtuous. Now this kind of training, which compels through fear of punishment, is the discipline of laws. Therefore in order that man might have peace and virtue, it was necessary for laws to be framed." (I–II, q. 95, a. 1)

A contemporary author in the same tradition, Robert P. George has summarized well the central idea in his book *Making Men Moral* (1993). In the language of economics, the principal reasons could be summarized in terms of *incentives*, *externalities (negative and positive)* and *information*:

> "Laws cannot make men moral. [...] Nevertheless, the central pre-liberal tradition of thought about morality, politics, and law has maintained that laws have a legitimate subsidiary role to play in helping people to *make themselves* moral. According to this tradition, laws forbidding certain powerfully seductive and corruptive vices (some sexual, some not) can help people to establish and preserve a virtuous character by (1) preventing the (further) self-corruption which follows from acting out a choice to indulge in immoral conduct; (2) preventing the bad example by which others are induced to emulate such behavior; (3) helping to preserve the moral ecology in which people make their morally self-constituting choices; and (4) educating people about moral right and wrong." (George, 1993: 1)

We might take examples from any field of law, but the relationship between law and virtue is most obvious in the case of *criminal law*, which in many ways upholds virtuous conduct and penalizes vice, even if this terminology seems old-fashioned today. Supposing that core criminal law would be entirely abolished (or would go unenforced), it is easy to picture the dynamic downward spiral in terms of personal morality (assuming, to be precise, that there are no non-legal sanctions on criminal acts either). Some, whose moral character is weak, would be unconstrained to engage in highly iniquitous acts, which they find attractive but which shape their moral character from bad to worse. Those of a more upright personality would feel discouraged by the failure of public authorities to punish the aggressors and put an end to rampant injustice. While

some might resist, others would yield to the temptation of injustice too. The lack of criminal prohibitions would also be perceived by many as an indication of common morality, so that their ideas of right and wrong would become distorted and their virtue of prudence weakened. In the extreme, a law of the jungle would arise where simply *might is right*. The only solution to such a state of affairs would be that some citizens rise up against the injustice, changing the laws of the society or at least setting up non-legal institutions to safeguard basic justice, and inspiring others through their moral example.

The dynamic perspective implies an important difference with respect to the static analysis: namely, that *people can chance*. In the static analysis, it was assumed for simplicity that the level of virtue is fixed. However, while virtue theory supposes certain stability of character, it also implies the *possibility of improvement* (and, of course, the possibility of *becoming corrupt*).

If the static analysis were taken too far, two problematic conclusions might be made. On the one hand, it might be argued that "once a criminal, always a criminal" – and therefore law should treat past criminals with outmost suspicion; in fact, it would be hard to escape the argument for death penalty, at least in the case of serious criminals. The problem is that the assumption is unrealistic and unjust, because it denies freedom of choice and even the ability to change.

On the other hand, it might be taken for granted that apparently virtuous persons are entirely incapable of unjust acts. This could lead into placing too much trust in them and vesting them with powers that, if abused, would lead to significant injustice.

These concerns have been noticed by Robert P. George, who takes issue with Aristotle and Aquinas on the extent to which it is appropriate to make any fundamental distinctions between different people when it comes to the development of virtue. Although people certainly are different, their basic tendencies and challenges are similar:

> "[T]here is in normal circumstances no reason to suppose, as Aristotle did, that the great mass of people are incapable of being reasonable and need to be governed by fear. Nor is there any reason to believe in the existence of a moral élite whose members need only understand moral truth in order to live up to its demands. The fact is that all rational human beings are capable of understanding moral reasons; yet all require guidance, support, and assistance from others. All are susceptible to moral failure, and serious moral failure; and all are capable of benefiting from a milieu which is more or less free from powerful inducements to vice." (George, 1993: 40)

These concerns highlight the importance of appropriate law and its enforcement in all fields, not only in criminal matters. Ayres and Braithwaite

(1992: 26) cite evidence to the effect that the majority of people obey laws voluntarily – but voluntary compliance drops significantly if violators are not duly punished. *Constitutional law* and *procedural law* are especially interesting in this context, because they seek to uphold the virtues of prudence and justice in the making and administration of the law itself. In fact, Aristotle in his *Politics* (1988) argues that the *rule of law* is a safeguard of justice, because few men are so virtuous as to be completely free from the influence of passions, which render one's judgments imperfect:

> "Therefore he who bids the law rule may be deemed to bid God and Reason alone rule, but he who bids man rule adds an element of the beast; for desire is a wild beast, and passion perverts the minds of rulers, even when they are the best of men. The law is reason unaffected by desire." (*Politics*, III, 16: 1287a29–33).

Aristotle admits that the law cannot provide for all the cases, but still the primacy of the rule of law remains:

> "Yet surely the ruler cannot dispense with the general principle which exists in law; and that is a better ruler which is free from passion than that in which it is innate. Whereas the law is passionless, passion must always sway the heart of man." (*Politics*, III, 15: 1286a15–20).

A range of principles and institutional safeguards have been developed to foster the exercise of prudence and justice in the making and enforcement of laws (see Finnis, 1980: 270-273). These include, among others, clear promulgation, coherence with other laws, prospectivity, possibility of being complied with, and stability; division of powers and of responsibilities in administering the law; independence of the judiciary; openness of court proceedings; the accountability of officials for not obeying the law; accessibility of the courts to all, including the poor; sounds rules of evidence; and many other procedural principles such as *audiatur et altera pars*, which is upheld by ensuring that both parties have sufficient time to make their case before their submissions are examined by the judge(s).

Naturally, the starting point in terms of the level of virtue has to be taken into account in the dynamic analysis too. This implies a kind of *gradualism* in the promotion of virtue, as explained by Aquinas in a work commonly known as *De Regno*. There he submits that the objective of the law-maker is threefold: "first of all, to *establish* a virtuous life in the multitude subject to him; second, to *preserve* it once established; and third, having preserved it, to promote its *greater perfection*." (Aquinas, 1949: I, 16, [117], emphases added).

A recent example of gradualism in practice is the ongoing anti-tobacco campaign. The anti-tobacco movement took to heart the lessons of the alcohol prohibition acts, and did not try to impose an outright ban on a substance to

which numerous people were deeply addicted. Instead, the strategy was to slowly steer social norms and public health perceptions against tobacco, and to push for laws which have gradually but systematically limited the sphere of legal rights of tobacco smokers.

The static analysis provides a framework for several dimensions of legal design which should change as society becomes more or less virtuous. Thus, if the level of virtue increases, the law should become gradually less constraining, yet more extensive and demanding; more precise and focusing on broader standards; opting for more persuasion than punishments; and providing for wider participation in the making and enforcement of the law. If the level of virtue decreases, the movement should be the opposite; this corresponds to the insights of the *enforcement pyramids* of Ayres and Braithwaite (1992).

4.4.2 Law *or* Virtue: A Negative Effect

Law is not always helpful for building up a virtuous society. The gradualism mentioned above showed how the dynamic view too, has to take the starting level into account. But it is not only the case that incorrectly designed law will be *imperfectly effective*: it may also be positively *harmful*.

One reason is that if the law has some practical effect on people's lives, they will respond to that law in one way or another, making either morally good or bad choices, and thus shaping their moral character for better or worse. This is noted by Aquinas in a famous response to the hypothetical objection that, if law should *not* repress all vices (as argued earlier), then surely our theory is *neglecting* the role of law in making men better. He answers by explaining that the issue is more complicated:

> "The purpose of human law is to lead men to virtue, not suddenly, but gradually. Wherefore it does not lay upon the multitude of imperfect men the burdens of those who are already virtuous, viz. that they should abstain from all evil. Otherwise these imperfect ones, being unable to bear such precepts, would break out into yet greater evils. [T]he precepts are despised, and those men, from contempt, break into evils worse still." (Aquinas, 1920: I–II, 96, 2, ad 2)

What Aquinas intuits is that law-makers need to strike a delicate balance between demanding too little and demanding too much – which is why legislators need a great deal of prudence. If the law demands too little, failing to prohibit some important vices and iniquitous activities, then many will feel uninhibited to practice those vices, thus making themselves worse in the process *and encouraging others* to follow in their footsteps. But if the law demands too much, a rebellion may follow. Of course, one must remember that virtue theory is not mathematics, and acquired habits (virtues and vices) only *condition* choices – they do not absolutely *determine* choices.

It might be countered that, surely, people rarely rebel simply because the law is too demanding, and therefore the concern is exaggerated. It is hard to determine whether that is true, and a more detailed investigation would be needed. Whatever the truth is, there are other reasons why overemphasizing the law may backfire. One of those is that *law as such* cannot turn anyone into a virtuous person:

> "Laws cannot make men moral. Only men can do that; and they can do it only by freely choosing to do the morally right thing for the right reason. Laws can command *outward conformity* to moral rules, but cannot compel the *internal acts of reason and will* which make an act of external conformity to the requirements of morality a moral act." (George, 1993: 1, emphases added)

One implication of this is that law is simply not enough. But there is more to it: forced outward conformity to virtuous behavior may sometimes be counterproductive if the corresponding development of internal attitudes is lacking. This idea can be found already in the writings of Confucius (2010):

> "If the people be led by laws, and uniformity sought to be given them by punishments, they will try to avoid the punishment, but have no sense of shame. If they be led by virtue, and uniformity sought to be given them by the rules of propriety, they will have the sense of shame, and moreover will become good." (*Analects*, 2, 3)

The underlying problem is that law is a clumsy instrument. Firstly, by its very nature, law focuses on *external acts*, whereas the development of virtuous dispositions requires (in addition to external acts) education in the *reasons* for those acts. Secondly, law tends to be *slow* in its reaction to unjust conduct (the prosecution of crimes may take months or years), whereas education in virtue calls for quick responses so as to rectify errors in time. Finally, the *disciplinary* nature of law may have negative secondary consequences:

> "Wise legislators whose goal is to encourage true moral goodness, and not merely the outward behavior that mimics true virtue, will therefore seek to secure and maintain a moral ecology that is inhospitable not only to such vices as pornography, prostitution, and drug abuse, but also to the vices of moral infantilism, conformism, servility, mindless obedience to authority, and hypocrisy." (George, 1993: 42–43)

The latter vices cannot be prohibited by law. Rather, a highly restrictive and repressive legal regime – apparently, perhaps, conducive to the avoidance of vice – will tend to foster those vices by failing to provide an atmosphere of *responsible freedom*.

Freedom is also needed for moral development for the reason that there are many good acts which are only meaningful if people choose them freely. Think, for example, of the expressing of gratitude, gift-giving, or the acknowledging of achievements: compelling such acts by force would render them without meaning or value (George, 1993: 44).

It therefore seems that an atmosphere of *confidence in human freedom* is necessary for the practice and development of virtue. This has been aptly pointed out by Barry Schwartz (2009), who argues that the virtue of practical wisdom cannot be developed without an environment in which people are allowed to make free choices – developing their *moral skill* – and in which the reason for acting is not merely external benefits but the good of doing the right thing to other people – developing their *moral will:*

> "When things go wrong, as of course they do, we reach for two tools to try to fix them. One tool we reach for is rules. Better ones, more of them. The second tool we reach for is incentives. Better ones, more of them. What else, after all, is there? We can certainly see this in response to the current financial crisis. Regulate, regulate, regulate. Fix the incentives, fix the incentives, fix the incentives... The truth is that neither rules nor incentives are enough to do the job. [...] And *what happens is that as we turn increasingly to rules, rules and incentives may make things better in the short run, but they create a downward spiral that makes them worse in the long run*. Moral skill is chipped away by an over-reliance on rules that deprives us of the opportunity to improvise and learn from our improvisations. And moral will is undermined by an incessant appeal to incentives that destroy our desire to do the right thing. And without intending it, *by appealing to rules and incentives, we are engaging in a war on wisdom.*" (Emphases added)

These concerns are implicitly reflected in the principles outlined in the static analysis: in order to promote the development virtue, it is necessary to give people freedom; to opt for broader standards rather than narrow rules only; to persuade with reasoned arguments, not compel by force only; and to provide opportunities for participation. To encourage virtue, the law must treat citizens as already (at least somewhat) virtuous. This means that the promotion of virtue implies risks. It is safer to impose strict limits and strong sanctions. But overly constraining and protective legal regimes may in the long term have an effect similar to that of "pampering" in child-rearing. Thus, for example, in contract law there has to be some degree of *caveat emptor*, because people can only develop their virtue of prudence by exercising their freedom and bearing the consequences.

In the field of regulation, it has similarly been argued that Ayres and Braithwaite (1992) that too restrictive and suspicious regulatory approaches

foster an unhealthy *compliance culture*, in which participants fulfill the norms out of fear of punishment, but will violate the rules when no one is looking. Given the imperfection of any legal regimes, the overall consequences are suboptimal. An interesting example is *the encoding of business ethics into law* (see the US Federal Sentencing Guidelines for Organizations). While the intention of behind such legislation must be laudable, some experts claim that the effects have been counterproductive (see Toffler with Reingold, 2003). They argue that people have started to "do business ethics" as a way of getting an advantage and avoiding legal problems, but the motivation has become distorted and, in the end, there is less interest in genuine business ethics based on the desire to do the right thing. Part of the problem in this case is that it is extremely difficult to encode business ethics into law, and trying to do so will easily create a superficial compliance culture.

4.4.3 Beyond Law: Other Dangers of Legal Perfectionism

It has been assumed for simplicity in the foregoing that when law-makers have a good reason to legislate something, they will indeed perform the task well. Naturally, that is an unrealistic assumption. Law may be imperfect in numerous ways, it tends to have unintended consequences, and legislators may simply be driven by less worthy goals than common good or the moral betterment of the citizens. This leads George (1993: 42) to submit that there are several *prudential considerations* which advice us to err on the side of freedom, and tolerate certain moral evils. These are:

> "(1) the need to avoid placing dangerous powers in the hands of governments that are likely to abuse them; (2) the danger that criminalization of certain vices may have the effect of placing monopolies in the hands of organized criminals who will market and spread the vices more efficiently; (3) the risk of producing secondary crimes against innocent parties; (4) the risk of diverting policy and judicial resources away from the prevention and prosecution of more serious crimes; (5) the concern that the power to enforce moral obligations will be exploited by puritanical, prudish, or disciplinarian elements in society to repress morally legitimate activities and ways of life whose genuine value these elements fail to appreciate; (6) the danger of establishing too much authority and creating a situation in which people relate primarily to a central authority whom they must constantly work to avoid offending, thus discouraging them from building genuine relationships with each other to the point of true friendship and valuable communities."

As to the last point raised by George, it was already Aristotle who recognized the importance of families and other intermediate associations for the education of virtues. Children have a natural affection for their parents, and as parents

know them well as individuals; each person has his or her challenges and weaknesses, and parents are better able to treat individuals as individuals than political authorities are (see *Nicomachean Ethics*, X, 9: 1180b). The same principle has been developed by many others:

"In the end, no amount of regulation – heavy or light – can substitute for the type of character formation that is supposed to occur in families, schools, churches, and synagogues. These are the institutions [...] which Adam Smith identified as primarily responsible for helping people develop what he called the 'moral sense' that causes us to know instinctively when particular courses of action are imprudent or simply wrong." (Gregg, 2008)

This is not to deny the fundamental role of law. Indeed, law is important for upholding what some have called the *moral ecology* of the society (Gregg, 2003: 53-55). This role includes, among others, supporting and maintaining the institutions of marriage and family, which are so important for the education of virtues and which are also, as history and common sense teach us, under constant threat due to the passions of men.

Some authors have argued that an undue focus on law may corrode valuable social norms, which are maintained by informal dealings that cannot be fruitfully regulated by law (Pildes, 1996). It has also been pointed out that the *language of rights* – so typical of law, and especially of human rights law – may create new kinds of conflicts and have a harmful effect on the virtue of justice, as it overemphasizes the *individual* at the expense of the community, fostering self-centered "maximization" behavior instead of search for the common good (Glendon, 1991).

4.4.4 A Synthesis

How do the static and dynamic perspectives work together? I argue in what follows that they form a harmonious system. The challenge is always to identify the correct starting point and then, according to the gradualism identified earlier, help towards greater virtue. But the way of helping towards virtue is precisely to adopt those legal strategies, which would be appropriate for virtuous people.

This is most evident in the case of *freedom generally* (see principle 1 in the static analysis). Persons who lack virtue need limits on their choices, whereas the highly virtuous can be given more freedom. But the unvirtuous too need freedom in order to develop their character. Having more freedom (fewer external constraints) is a condition *sine qua non* for the growth of virtue, because virtue ultimately requires the making of *right choices, for the right reasons, and freely*. A virtuous disposition is not based on mere prohibitions, but on the moral goodness of the choice. Prudence cannot develop if people are not able to make choices, to "improvise" and "learn from their improvisations" (Schwartz, 2009). And the virtue of justice cannot develop if people are merely guided by stick and carrot. Likewise, fortitude and temperance as virtues will only develop

through personal choices. Of course, the right balance must be found, because freedom is challenging and can also become destructive for oneself and others: "All [human beings] require freedom if they are to flourish; and unlimited freedom is the enemy, not the friend, of everyone's well-being" (George, 1993: 40).

The same seems to be true of the other dimensions of legal design. Law can impose *greater demands* on the virtuous, whereas those who lack virtue cannot be asked for what they cannot give. However, demanding more is necessary in order to pull others towards virtue. In the famous words of Goethe: "Treat a man as he appears to be, and you make him worse. But treat a man as if he were what he potentially could be, and you make him what he should be."

Likewise, the virtuous can be governed with *broad standards*, while those who lack virtue need more specific rules. But the use of standards is also a way of helping people to develop their moral skill, because broader norms have a closer connection with the principles of justice, and they are an invitation to personal reflection on one's choices. In contrast, trying to write a narrow rule for every situation leads into the trap of an excessive casuistry, which is inconsistent with true moral wisdom (Pieper, 1966: 26–27).[35] In legal scholarship, it has also been argued that broader standards might encourage a culture of honesty, thus helping to develop the virtue of justice (Partnoy, 1997; 2003: 409). The use of standards, when possible, is also consistent with Lawrence Kohlberg's famous theory of moral development, which goes all the way from obedience-based morality to universal ethical principles (Kohlberg, 1973).

As far as *sanctions* are concerned, it again turns out that the more persuasive approach, which is suited to the virtuous, is also conducive to the development of the virtues. Harsh penalties may be needed when nothing else works, but they are not likely to foster genuine virtues. In contrast, sanctions based on guidance, information, and soft and informal penalties are educationally more effective, because they are more likely to appeal to the intrinsic motivation to do the right thing.

In *law-making and enforcement*, a greater level of virtue implies that more can be trusted to self-governance. But again, self-governance seems to go hand-in-hand with the development of virtue, because it fosters a sense of responsibility for oneself and others. Ultimately self-governance is just one manifestation of freedom.

In addition to these dimensions in the static analysis, it was argued in the dynamic part that the development of virtue greatly depends on other factors than law: strong families, good educators, a thriving civil society, and moral exemplars. Yet these, too, are connected with the other principles: healthy family

---

[35] Pieper (1966: 27) writes: "Casuistry [...] must be regarded as no more than a highly useful, and probably necessary, aid; certainly not as an absolute standard for making ethical judgments and performing concrete ethical actions. To confound model and reality, to put too great a valuation on casuistry, is equivalent to misunderstanding the meaning and rank of the virtue of prudence."

life and a thriving civil society are only possible in an atmosphere of freedom, trust and personal initiative; the task of law is to create a sound, broad framework in which the other institutions can flourish.

5 CONCLUSION

This essay has demonstrated the fruitfulness of classical virtue theory in the context of law and economics. It has argued that the notion of virtues can be imported into economic analysis, and that the practical significance of the *virtue factor* in economic life is potentially significant. It has also outlined a general framework for the analysis of law from a virtue-based perspective, showing how optimal legal design depends on the level of virtue of the citizens.

Six general principles were identified: (1) virtue goes together with more freedom, while lack of virtue calls for more legal and regulatory constraints; (2) virtue goes together with more demanding law, while lack of virtue calls for less demanding law; (3) virtue goes together with more precise laws, while lack of virtue calls for less legal precision; (4) virtue goes together with broad standards, while lack of virtue calls for narrow rules; (5) virtue goes together with lighter enforcement and sanctions, while lack of virtue calls for harsher punishments; and (6) virtue goes together with more participation in law-making and law-enforcement, while lack of virtue implies less participation.

It was also pointed out that there are various ways in which one could gather information about the level of virtue in society, and laws and regulations may be designed in ways that account for the moral heterogeneity of the citizens. Finally, it was found the law plays a major role in promoting and safeguarding virtues, but legal perfectionism may be counterproductive.

The argument and framework developed here is but a sketch, and much more work, both theoretical and empirical, remains to be done. Let's get to work.

REFERENCES

Akerlof, George A. (1991), Procrastination and Obedience, *American Economic Review* 81(2), 1-19.

Andres, Christian and Erik Theissen (2008), Setting a Fox to Keep the Geese — Does the Comply-or-explain Principle Work?, *Journal of Corporate Finance*, 14(3), 289-301.

Arcot, Sridhar, Valentina Bruno and Antoine Faure-Grimaud (2010), Corporate governance in the UK: Is the comply or explain approach working?, *International Review of Law and Economics*, 30(2), 193-201.

Aquinas (1949), *De Regno: On Kingship to the King of Cyprus*, translated by Gerald B. Phelan, Toronto: The Pontifical Institute of Mediaeval Studies, available online at http://dhspriory.org/thomas/DeRegno.htm (17.2.2012).

Aquinas (1920), *Summa Theologica*, translated by the Fathers of the English Dominican Province, Online edition, http://www.newadvent.org/summa (17.2.2012).

Arias, Oscar (2011), Culture Matters: The Real Obstacles to Latin American Development, *Foreign Affairs*, 90(1), 2–6.

Aristotle (1980), *The Nicomachean Ethics,* translated by D. Ross, revised by J. L. Ackrill and J. O. Urmson, Oxford University Press.

Aristotle (1988), *The Politics*, translated by Benjamin Jowett, Cambridge, U.K.: Cambridge University Press.

Arrow, Kenneth (1972), Gifts and Exchanges, *Philosophy & Public Affairs*, 1(4), 343-362.

Athanassoulis, Nafsika (2000), A Response to Harman: Virtue Ethics and Character Traits, *Proceedings of the Aristotelian Society*, 100, 215-221.

Ayres, Ian and John Braithwaite (1992), *Responsive Regulation: Transcending the Deregulation Debate*, Oxford and New York: Oxford University Press.

Bagus, Philipp (2011), *The Tragedy of the Euro*, second edition, Eastbourne: Terra Libertas.

Becker, Gary S. (1968), Crime and Punishment: An Economic Approach, *Journal of Political Economy*, 76, 169-217.

Becker, Gary S. (1976), *The Economic Approach to Human Behavior*, Chicago University Press.

Becker, Gary S. (1992), The Economic Way of Looking at Life, Nobel Lecture, December 9, 1992.

Becker, Gary S. (1993), *Human Capital: A Theoretical and Empirical Analysis, with Special Reference to Education*, third edition, Chicago University Press.

Becker, Gary S. (1996), *Accounting for Tastes*, Harvard University Press.

Becker, Gary and Kevin Murphy (1988), A Theory of Rational Addiction, *Journal of Political Economy*, 96, 675–700.

Bentham, Jeremy [1789] (1970), *An Introduction to the Principles of Morals and Legislation*, edited by J.H. Burns and H.L.A. Hart, London: The Athlone Press.

Black, Julie (2010), *The Rise, Fall and Fate of Principles Based Regulation*, LSE Legal Studies Working Paper No. 17/2010.

Blocker, Jack S., Jr (2006), Did Prohibition Really Work? Alcohol Prohibition as a Public Health Innovation, *American Journal of Public Health*, 96(2), 233–243.

Bowles, Samuel and Herbert Gintis (2002), Social Capital and Community Governance, *Economic Journal*, 112, 419–36.

Burke, Edmund (1791), *A letter from Mr. Burke to a Member of the National Assembly in Answer to Some Objections to His Book on French Affairs*, London: J. Dodsley.

Bruni, Luigino and Pier Luigi Porta (2006), *Economics and Happiness: Framing the Analysis*, Oxford University Press.

Camerer, Colin F., George Loewenstein and Matthew Rabin (eds) (2004), *Advances in Behavioral Economics,* Princeton University Press.

Casterline, Rick (2006), Berkshire Behind the Scenes: Part 5, *Motley Fool*, June 1, http://www.fool.com/investing/value/2006/06/01/berkshire-behind-the-scenes-part-5.aspx (17.2.2012).

Coase, Ronald H. (1994), Economics and Contiguous Disciplines, in *Essays on Economics and Economists*, Chicago and London, University of Chicago Press.

Confucius (2010), *The Analects of Confucius*, translated by James Legge, eBooks@Adelaide (web edition), University of Adelaide Library.

Dal Bó, Ernesto and Marko Terviö (2008), Self-Esteem, Moral Capital, and Wrongdoing, NBER Working Paper No. 14508.

Dasgupta, Partha (2008), Social Capital, in Steven N. Durlauf and Lawrence E. Blume (Eds), *The New Palgrave Dictionary of Economics Online*, Second Edition, Palgrave Macmillan, http://www.dictionaryofeconomics.com/article?id=pde2008_S000451 (17.2.2012).

Dnes, Antony W. (1996), *The Economics of Law*, London: Sweet & Maxwell.

Doris, John (1998), Persons, Situations, and Virtue Ethics, *Nous*, 32(4), 504-530.

Doris, John M. (2002), *Lack of Character: Personality and Moral Behavior*, Cambridge University Press.

Fanfani, Amintore (1984), *Catholicism, Protestantism, and Capitalism* (Notre Dame, IN: University of Notre Dame Press).

Feldstein, Martin (1997), The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability, *Journal of Economic Perspectives*, 11(4), 23-42.

Finn, Daniel R. (1998), John Paul II and the Moral Ecology of Markets, *Theological Studies*, 59(4), 662-679.

Finnis, John (1980), *Natural Law and Natural Rights*, Oxford University Press.

Finnis, John (1998), *Aquinas: Moral, Political, and Legal Theory*, Oxford University Press.

Fisher, Irving (1930), *The Theory of Interest: As Determined by Impatience to Spend Income and Opportunity to Invest It*, New York: Macmillan.

Fitzgibbons, Athol (1995), *Adam Smith's System of Liberty, Wealth, and Virtue: The Moral and Political Foundations of the "Wealth of Nations"*, Oxford: Clarendon Press.

Foot, Filippa R. (1978), *Virtues and Vices*. Berkeley, CA: University of California Press.

Ford, Cristie (2010), Principles-Based Securities Regulation in the Wake of the Global Financial Crisis, *McGill Law Journal*, 55, 257-307.

Forst, Rainer (2007), Toleration, in *Stanford Encyclopedia of Philosophy*, Fall 2008 Edition, Edward N. Zalta (ed.), http://plato.stanford.edu/archives/fall2008/entries/toleration (17.2.2012).

FSA (2007), Principles-based regulation: Focusing on the outcomes that matter, Financial Services Authority, UK, April 2007.

FSA (2009), The Turner Review: A regulatory response to the global banking crisis, Financial Services Authority, UK, March 2009.

Frank, Robert H. (1987), If *Homo Economicus* Could Choose His Utility Functions, Would He Want One With a Conscience?, *American Economic Review*, 77, 593-604.

Frank, Robert H. (1988), *Passions within Reason*, New York: W.W. Norton

Frank, Robert H. (2004), *What Price the Moral High Ground? Ethical Dilemmas in Competitive Environments*, Princeton and Oxford: Princeton University Press.

Friedman, Milton (1953), *Essays in Positive Economics*, University of Chicago Press.

Fukuyama Francis (1995), *Trust: The Social Virtues and the Creation of Prosperity*, New York: Free Press.

Geach, Peter (1977), *The Virtues*, Cambridge, UK: Cambridge University Press.

George, Robert P. (1993), *Making Men Moral: Civil Liberties and Public Morality*, Oxford: Clarendon Press.

Glendon, Mary Ann (1991), *Rights Talk: The Impoverishment of Political Discourse*, New York: Free Press.

Gregg, Samuel (2003), *On Ordered Liberty: A Treatise on the Free Society*, Lanham and Oxford: Lexington Books.

Gregg, Samuel (2007), *The Commercial Society: Foundations and Challenges in a Global Age*, Lanham: Lexington Books.

Gregg, Samuel (2008), Credit Crunch, Character Crisis, paper presented at Thomas More Institute, London, 22 October, http://www.thomasmoreinstitute.org.uk/node/140 (17.2.2012).

Gregg, Samuel (2009), Metaphysics and Modernity: Natural Law and Natural Rights in Gershom Carmichael and Francis Hutcheson, *Journal of Scottish Philosophy*, 7(1), 87-102.

Hagstrom, Robert G. (2005), *The Warren Buffett Way: Investment Strategies of the World's Greatest Investor*, Hoboken: Wiley.

Hall, Wayne (2010), What Are the Policy Lessons of National Alcohol Prohibition in the United States, 1920-1933?, *Addiction*, 105(7), 1164-73.

Hanley, Ryan Patrick (2009), Social Science and Human Flourishing: The Scottish Enlightenment and Today, *Journal of Scottish Philosophy*, 7(1), 29-46.

Harman, Gilbert (1999), Moral philosophy meets social psychology: virtue ethics and the fundamental attribution error, *Proceedings of the Aristotelian Society*, 99(3), 315-331.

Harman, Gilbert (2000), The Nonexistence of Character Traits. *Proceedings of the Aristotelian Society*, 100, 223-226.

Harrison, Lawrence E. (1993), *Who Prospers: How Cultural Values Shape Economic And Political Success*, New York: Basic Books.

Harrison, Lawrence E. (2000), *Underdevelopment Is a State of Mind: The Latin American Case*, updated edition, Madison, WI: Madison Books.

Harrison, Lawrence E. and Samuel P. Huntington (eds) (2001), *Culture Matters: How Values Shape Human Progress*, New York: Basic Books.

Havard, Alexandre (2007), *Virtuous Leadership: An Agenda for Personal Excellence*, New York: Scepter Publishers.

Jensen, Michael C. and William H. Meckling (1994), The Nature of Man, *Journal of Applied Corporate Finance*, 3, 4-19.

John Paul II (1987), Address to the U.N. Economic Commission for Latin America and the Caribbean, Santiago, Chile, April 3; published in *Origins*, 16, 773-76.

Jolls, Christine, Cass R. Sunstein and Richard H. Thaler (2000), A Behavioral Approach to Law and Economics, in Cass R. Sunstein (ed.), *Behavioral Law and Economics*, Cambridge University Press, pp. 13-58. Originally published in *Stanford Law Review* 50 (1998), 1471-1550.

Kamtekar, Rachana (2004), Situationism and Virtue Ethics on the Content of Our Character, *Ethics*, 114(3), 458-491.

Kant, Immanuel (1925), *Eine Vorlesung Kants über Ethik*, second edition, ed. Paul Menzer, Berlin: Pan Verlag Rolf Heise.

Kaplow, Louis (1992), Rules versus Standards: An Economic Analysis, *Duke Law Journal*, 42, 557-629.

Kaplow, Louis (2000), General Characteristics of Rules, in Bouckaert, Boudewijn and Gerrit De Geest (eds.), *Encyclopedia of Law and Economics, Volume V: The Economics of Crime and Litigation*, Cheltenham, Edward Elgar, 502-528.

Kohlberg, Lawrence (1973), The Claim to Moral Adequacy of a Highest Stage of Moral Judgment, *Journal of Philosophy*, 70(18), 630-646.

Kruschwitz, Robert B. and Robert C. Roberts (1987), *The Virtues: Contemporary Essays on Moral Character*, Belmont, CA: Wadsworth.

Kupperman, Joel J. (2001), The Indispensability of Character, *Philosophy*, 76, 239-250.

Landes, David S. (1999), *The Wealth and Poverty of Nations: Why Some Are So Rich and Some So Poor*, New York: W. W. Norton & Company.

Landes, William M. and Richard A. Posner (1981), The Positive Economic Theory of Tort Law, *Georgia Law Review*, 15, 851-924.
Lewis, C. S. (2001), *The Abolition of Man*, Grand Rapids, MI: Zondervan.
Lindbeck, Assar and Sten Nyberg (2006), Raising Children to Work Hard: Altruism, Work Norms, and Social Insurance, *Quarterly Journal of Economics*, 121(4), 1473-1503.
Lindbeck, Assar, Sten Nyberg and Jörgen W. Weibull (1999), Social Norms and Economic Incentives in the Welfare State, *Quarterly Journal of Economics*, 114(1), 1-35.
Loewenstein, George, Ted O'Donoghue and Matthew Rabin (2003), Projection Bias in Predicting Future Utility, *Quarterly Journal of Economics* 118(4), 1209-1248.
Toffler, Barbara Ley with Jennifer Reingold (2003), *Final Accounting: Ambition, Greed and the Fall of Arthur Andersen*, Broadway Books.
Machina, Mark (1987), Choice Under Uncertainty: Problems Solved and Unsolved, *Journal of Economic Perspectives*, 1, 121-154.
MacIntyre, Alasdair (1984), *After Virtue*, second edition, Notre Dame, IN: University of Notre Dame Press.
MacIntyre, Alasdair (1987), *Whose Justice? Which Rationality?*, Notre Dame, IN: University of Notre Dame Press.
MacIntyre, Alasdair (1991), Incommensurability, Truth, and the Conversation between Confucians and Aristotelians about the Virtues, in Eliot Deutsch (ed.), *Culture and Modernity*, Honolulu: University of Hawaii Press, 104-122.
MacIntyre, Alasdair (2004), Once More on Confucian and Aristotelian Conceptions of the Virtues, in Robin Wang (ed.), *Chinese Philosophy in an Age of Globalization*, Albany: State University of New York Press, 151-162.
McCloskey, Deirdre (2006), *The Bourgeois Virtues: Ethics for an Age of Commerce*, Chicago University Press.
McCloskey, Deirdre (2008), Adam Smith, the Last of the Former Virtue Ethicists, *History of Political Economy*, 40(1), 43-71.
Milgram, Stanley (1963), Behavioral Study of Obedience, *Journal of Abnormal and Social Psychology*, 67(4), 371-378.
Miller, Christian (2003), Social Psychology and Virtue Ethics, *Journal of Ethics*, 7(4), 365-392.
Mironov, Maxim (2005), Bad Corruption, Good Corruption and Growth, unpublished working paper, http://www.mironov.fm/research/corruption.pdf (17.2.2012).
Montmarquet, James (2003), Moral Character and Social Science Research, *Philosophy*, 78, 355-368.
North, Douglass C. (1990), *Institutions, Institutional Change and Economic Performance*, Cambridge University press.
O'Donoghue, Ted and Matthew Rabin (1999), Doing it Now or Later, *American Economic Review* 89(1), 103-124.
Ogus, Anthony (2000), Self-Regulation, in Bouckaert, Boudewijn and Gerrit De Geest (eds.), *Encyclopedia of Law and Economics, Volume V: The Economics of Crime and Litigation*, Cheltenham, Edward Elgar, 587-602.
Ogus, Anthony (2004), What Legal Scholars Can Learn from Law and Economics, *Chicago-Kent Law Review*, 79, 383-401.
Oosterbeek, Hessel, Randolph Sloof and Gijs van de Kuilen (2004), Cultural Differences in Ultimatum Game Experiments: Evidence from a Meta-Analysis, *Experimental Economics*, 7(2), 171–188.

Otteson, James R. (2000), The Recurring "Adam Smith Problem", *History of Philosophy Quarterly*, 17(1), 51-74.

Otteson, James R. (2002), *Adam Smith's Marketplace of Life*, Cambridge University Press.

Otteson, James R. (2011), *Adam Smith*, Continuum Press.

Panther, Stephan (2000), Non-legal Sanctions, in Boudewijn Bouckaert and Gerrit Geest (eds), *Encyclopedia of Law and Economics, Volume I: The History and Methodology of Law and Economics*, Cheltenham: Edward Elgar, 999-1028.

Partnoy, Frank (1997), Financial Derivatives and the Costs of Regulatory Arbitrage, *Journal of Corporation Law*, 22, 211.

Partnoy, Frank (2003), *Infectious Greed: How Deceit and Risk Corrupted the Financial Markets*, Times Books.

Peterson, Christopher and Martin E. P. Seligman (2004), *Character Strengths and Virtues*, Oxford: Oxford University Press.

Pieper, Josef (1966), *The Four Cardinal Virtues*, Notre Dame, IN: University of Notre Dame Press.

Pildes, Richard H. (1996), The Destruction of Social Capital through Law, *University of Pennsylvania Law Review*, 144, 2055-2077.

Posner, Richard A. (1989), Some Uses and Abuses of Economics in Law, *University of Chicago Law Review*, 46, 281-306.

Putnam, Hilary (2002), *The Collapse of the Fact/Value Dichotomy and Other Essays*, Cambridge: Harvard University Press.

Rabin, Matthew (1998), Psychology and Economics, *Journal of Economic Literature* 36, 11-46.

Rocha, Hector O. and Sumantra Ghoshal (2006), Beyond Self-Interest Revisited, *Journal of Management Studies*, 43(3), 585-619.

Sabini, John and Maury Silver (2005), Lack of Character? Situationism Critiqued, *Ethics*, 115(3), 535-562.

Sachs, Joe (2005), Aristotle: Ethics, *Internet Encyclopedia of Philosophy*, http://www.iep.utm.edu/aris-eth (17.2.2012).

Schäfer, Hans-Bernd (2002), Legal Rules and Standards, *German Working Papers in Law and Economics*, 2/2002.

Schlag, Pierre (1985), Rules and Standards, *UCLA Law Review*, 33, 379-430.

Schroeder, Alice (2008), *The Snowball: Warren Buffett and the Business of Life*, New York: Bantam.

Schultz, Theodore (1971), *Investment in Human Capital: The Role of Education and of Research*, New York: Free Press.

Schwarcz, Steven L. (2009), The 'Principles' Paradox, *European Business Organization Law Review*, 10(2), 175-184.

Schwartz, Barry (2009), *Barry Schwartz on Our Loss of Wisdom*, TED Conference, February 2009, http://www.ted.com/talks/barry_schwartz_on_our_loss_of_wisdom.html (17.2.2012).

Sen, Amartya K. (1977), Rational Fools: A Critique of the Behavioral Foundations of Economic Theory, *Philosophy & Public Affairs*, 6(4), 317-344.

Sen, Amartya (1987), *On Ethics and Economics*, Oxford and New York: Basil Blackwell.

Sen, Amartya K. (2002), *Rationality and Freedom*, Cambridge, MA: Belknap Press of Harvard University Press.

Sim, May (2007), *Remastering Morals with Aristotle and Confucius*, Cambridge University Press.

Sim, May (2010), Rethinking Virtue Ethics and Social Justice with Aristotle and Confucius, *Asian Philosophy*, 20(2), 195-213.

Simon, Herbert A. (1947), *Administrative Behavior: A Study of Decision-Making Processes in Administrative Organizations*, New York: MacMillan.

Simon, Herbert A. (1955), A Behavioral Model of Rational Choice, *Quarterly Journal of Economics* 69, 99-118.

Sirico, Robert A. (2001), *The Entrepreneurial Vocation*, Grand Rapids, MI: Acton Institute.

Sison, Alejo (2003), *The Moral Capital of Leaders: Why Virtue Matters*, Cheltenham, UK: Edward Elgar.

Skog, Ole-Jørgen (2000), Addict's Choice, *Addiction*, 95, 1309-1314.

Skog, Ole-Jørgen (2005), Addiction, Choice, and Irrationality, in Francesco Parisi and Vernon L. Smith (eds), *The Law and Economics of Irrational Behavior*, Stanford, CA: Stanford University Press, 111–140.

Smith, Adam [1759] (1976), *The Theory of Moral Sentiments*, edited by D. D. Raphael and A. L. Macfie, Indianapolis: Liberty Classics.

Smith, Adam [1776] (1976), *An Inquiry into the Nature and Causes of the Wealth of Nations*, edited by R. H. Campbell and A. S. Skinner, Oxford: Clarendon Press.

Solomon, Robert C. (2003), Victims of Circumstances? A Defense of Virtue Ethics in Business, *Business Ethics Quarterly*, 13(1), 43-62.

Sowell, Thomas (1994), *Race and Culture: A World View*, New York: Basic Books.

Sowell, Thomas (1996), *Migrations and Cultures: A World View*, New York: Basic Books.

Sreenivasan, Gopal (2002), Errors about Errors: Virtue Theory and Trait Attribution, *Mind*, 111, 47-68.

Stigler, George J. (1961), The Economics of Information, *Journal of Political Economy*, 69(3), 213-225.

Stigler, George J. and Gary S. Becker (1977), De Gustibus Non Est Disputandum, *American Economic Review*, 67(2), 76-90.

Sunstein, Cass R. (1995), Problems with Rules, *California Law Review*, 83, 953-1023.

Sunstein, Cass R. (1996), On the Expressive Function of Law, *University of Pennsylvania Law Review*, 144(5), 2021-2053.

Szasz, Thomas S. (1972), Bad Habits Are Not Diseases: A Refutation of the Claim That Alcoholism Is a Disease, *Lancet*, 2, 83-84.

Tversky, Amos and Daniel Kahneman (1973), Availability: A Heuristic for Judging Frequency and Probability, *Cognitive Psychology* 5, 207-232.

Tversky, Amos and Daniel Kahneman (1974), Judgment under Uncertainty: Heuristics and Biases, *Science* 185, 1124-1131.

Udall, Maxine (2010), The Economic Rewards of Virtue, 05/01/2010, http://www.maxineudall.com/2010/05/the-rewards-of-virtue.html (17.2.2012).

Van Praag, Bernard M. S. and Ada Ferrer-i-Carbonell (2007), *Happiness Quantified: A Satisfaction Calculus Approach*, Oxford University Press.

Vogel, David (2005), *The Market For Virtue: The Potential And Limits Of Corporate Social Responsibility*, Washington, DC: Brookings Institution Press.

Weber, Max [1905] (1958), *The Protestant Ethic and the Spirit of Capitalism*, trans. Talcott Parsons, New York: Scribner.

Wihlborg, Clas, Thomas D. Willett and Nan Zhang (2010), The Euro Debt Crisis: It Isn't Just Fiscal, *World Economics*, 11(4), 51-77.

Williams, Bernard (1985), *Ethics and the Limits of Philosophy*, Cambridge: Harvard University Press.

Yu, Jiyuan (1998), Virtue: Confucius and Aristotle, *Philosophy East and West*, 48(2), 323-347.

Yu, Jiyuan (2007), *The Ethics of Confucius and Aristotle: Mirrors of Virtue*, New York and London: Routledge.

Oskari Juurikkala

Essays on Psychology and Morality in Economic Analysis of Law

There is nothing more practical than a good theory. The dissertation seeks to improve our understanding of law by building on new developments in economic theory, focusing on the role of psychology and morality.

The author is a researcher at the Institute of International Economic Law, University of Helsinki.

Publications of the University of Eastern Finland
Dissertations in Social Sciences and Business Studies

ISBN (PDF) 978-952-61-0742-4
ISSN (PDF) 1798-5757