

IMPORT, EXPORT, AND MULTILATERAL TRANSLATION: METHODOLOGICAL LESSONS FROM AN ECONOMIC ANALYSIS OF PATERNALISM IN CONTRACT LAW

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In this paper I discuss the conceptual and methodological background of an economic approach to paternalism in contract law. This should serve as a case study to a more general problem: the role of inter- and multidisciplinary research in jurisprudence and legal studies in general.

Motives and methods of analysing legal paternalism

In recent years, contract regulation and legal paternalism have raised interest within both American legal academia and European private law scholarship. There are several reasons for this: the practical ones are related to the revision of the consumer *aquis* and the ongoing discussion regarding the pros and cons of the harmonization of contract law in the European Union. Understandably, this subject induces, eager interest, both academic and practical. This interest is nurtured by theoretical considerations as well. First, contract regulation and paternalism draw attention to the philosophical and methodological difficulties involved in the justification of the limitations on freedom of contract. Second, they demonstrate that empirical findings on human behaviour may lead, in many cases, to conclusions, especially policy recommendations that are significantly different from the outcomes of traditional economic arguments.

More specifically, in the law and economics literature, the question has been raised as to whether the traditional anti-paternalist view of mainstream economics based on “consumer sovereignty” remains valid if (at least) one contracting party is imperfectly rational or not fully informed. Furthermore, as some of these imperfections of judgment and choice behaviour characterize humans generally, legislators and regulators with the task of setting a legal framework for contracting, or judges and juries

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involved in individual contract disputes, are not necessarily immune from these biases either. Thus the question should be raised whether the traditional anti-paternalistic stance of law and economics has to be modified, or even replaced, by anti-antipaternalism: a limited and critical version of paternalism.¹

In order to give a flavour of the complexity of the problems concerning paternalism in contract law, let me give an example here. Usury laws have a very long history, and not only in the Christian world.² Laws limiting the interest rate for credits have been in force in many legal systems; they are not uncommon in today's Europe either. For instance, in France the maximum interest rate is regulated in the *Code de la consommation* in a detailed manner.³ In England, usury has been traditionally prohibited by both statutes and judicial decisions. In Germany, judges regulate usury with reference to §138 I of the BGB (*Bürgerliches Gesetzbuch*).⁴

By prohibiting usurious contracts, the law does not allow people to grant and take on credits on very harsh or unbalanced terms. To be sure, financial contracts are also heavily regulated in other ways. For instance, the purpose of modern consumer credit regulation is to provide consumers with all the information necessary to allow for a rational decision.

With regard to this kind of regulation one could ask the following question: if consumers are aware of the conditions of the credit contract and the relevant market is workably competitive, how can any substantive limit such as a cap on the interest rates be justified? In other words, if usury laws are unnecessary for controlling the circumstances surrounding the contracting situation (this job is done by rules on fraud, duress, and information disclosure) they do not ever seem necessary. Eventually, such laws could be defended by paternalism, redistributive arguments, substantive fairness, or with reference to widely shared moral principles; but how compatible are they with another widely held principle, freedom of contract?

A related issue is that usury laws can be counter-productive. By prohibiting credit contracts with interest rates above a given limit, the law makes it impossible for certain consumers to legally access credit, as their default risk, and thus the interest rate, is so high that in a competitive credit market there is no (private) bank prepared to lend to them below the legally fixed maximum rate. Consequently, some potentially mutually beneficial transactions do not take place, and those whom the law wanted to protect are possibly made worse off. Usury laws make "it more difficult for poor people to borrow, thus harming them *ex ante* though benefiting some of them *ex post*."⁵

Another question that arises, concerns the way usury laws actually work in practice. In a recent article, Hynes and Posner give an overview of usury laws in force

¹ "[B]ounded rationality pushes toward a sort of anti-antipaternalism – a skepticism about antipaternalism, but not an affirmative defense of paternalism." Jolls – Sunstein – Thaler 2000: 46. See also Trout 2005.

² Cf. Baldwin 1959. For instance, according to an ancient Hindu rule called *damdupat*, interest in excess of the principal cannot be recovered. A similar rule was also codified in the *Usurious Loans Act, 1918* in India, see http://punjabrevenue.nic.in/usurious_loan_act.htm.

³ For the English text of the relevant regulation see <http://195.83.177.9/code/liste.phtml?lang=uk&c=30&r=1503>.

⁴ For a historical and comparative overview of usury laws see Menyhárd 2004: 33-47.

⁵ Posner 1998: 129.

in the different states of the U.S.⁶ Some state laws are very restrictive, others more lenient. As the authors also demonstrate, there are many ways to make these restrictions ineffective through contractual arrangements. At least in the United States, strict usury laws are hardly relevant in practice.

It is interesting to note that some legal systems seem to have found ways to deal with the problem of poor (high-risk) debtors mentioned above. In South Africa, the Supreme Court “has decided that micro-lenders operate under exemptions to the Usury Act which give them the freedom to charge unrestricted interest on loans under R10000 (EUR 1400). The interest rates for such credits are often higher than 50 per cent per year and sometimes even higher.”⁷ This South-African example seems to reflect the court’s understanding that there is a group of, probably low-income, people who need a special regime. In this market segment, credit is only viable at a relatively high interest rate, because of the high average default risk of the borrowers as a group. Thus this ruling of the Supreme Court is probably efficient, i.e. mutually beneficial from an *ex ante* perspective. It makes it possible for borrowers of smaller amounts to take credit legally. *Given their current set of opportunities* it serves the interest of the low-income group as well.

Not surprisingly, when consumer credit is more easily available, there is more credit outstanding, and more cases of overindebtedness. As psychological studies confirm, people are not rational in taking on credit: they fall prey to cognitive and emotional biases which make their decisions erroneous, even measured on the scale of their own interest. Currently there is intensive discussion about the possible causes of, and policy responses to, consumer overindebtedness throughout the world.⁸ The potential policy responses can be preventive ones working *ex ante*, including the provision of adequate information, cooling-off periods and other procedural limits. Meanwhile, other measures may help to get out of indebtedness *ex post*. There are many promising initiatives which give assistance to consumers not only financially but by providing information about rational management of personal finances. For instance, NGOs work on designing and distributing easily accessible information, like brochures with simple rules of thumb and vivid illustrations about how to notice the threat, and then fight the danger of overindebtedness. As we will see later, this is an instance of what is called “debiasing through law”, a research idea suggested in behavioural law and economics.

As a sort of indirect paternalism, another way of intervening is to regulate the behaviour of the lenders. The many “Fairness in Lending Acts” in the U.S, have, starting from the 1970s, basically mandated that the true costs of credit should be communicated to the consumer. As I will argue below, while these information provision rules are not unnecessary, unfortunately, they seem insufficient. Typically, they do not help when consumers take credits knowingly but irresponsibly. One of the current regulative ideas which is supposed to address this problem, parallel to helping borrowers, is promoted under the label of “responsive lending”. The term refers to voluntarily assumed norms of ethical and responsive business. Indeed, it resonates with

⁶ For a recent critical summary of the economic arguments and the legal rules of the US, see Hynes – Posner 2002.

⁷ Personal communication from Prof. Hans-Bernd Schäfer (Hamburg). For a detailed analysis see Meagher 2005.

⁸ See, e.g. <http://www.responsible-credit.net/>.

some jurisprudential arguments which seek to include the principle of “transactional care”⁹ into contract law in order to counteract exploitation.

“Responsive lending” and “transactional care” are terms with strong moral undertones. What could be the theoretical and normative background of these ideas? Why am I my brother’s keeper? Such ideas can have different philosophical roots and justifications. Arguments in favour of paternalism by a better informed (endowed) fellow citizen, or transactional partner (and not the state) are in part based on the idea that not only legal norms matter: rather, social norms do, and should, regulate which business practices are considered fair and socially acceptable.

As the 2007 subprime mortgage financial crisis indicates, irresponsible lending (in a wider sense) may have also serious macroeconomic effects. Even a non-paternalistic state may have reasons for intervention in certain circumstances. These widespread economic consequences also indicate that the impact of credit contracts definitely goes beyond the competencies and capacities of contract law and the judicial system.

In sum, the example of the regulation of credit contracts between formally equal but economically powerful and weak parties suggests four general ideas.

- (1) Throughout history, policymakers have regulated such transactions using various justifications.
- (2) In modern legal systems, a wide variety of legal instruments are used for paternalistic purposes, these can be compared with regards to their effectiveness.
- (3) Economic theory can illuminate these issues.
- (4) As these contracts are embedded in a social context, understanding this contextual richness requires going beyond the standard economic approach.

Regulatory doctrines in contract law

To be sure, these ideas are not completely new. For judges solving contract disputes, their policing role in regards to labor, consumer and other standard-form contracts has become increasingly apparent since the early 20th century. Since then, there have been several types of cases where modern legal regimes have set limits upon the general principle of freedom of contract. In fact, many contract law rules do not aim at enforcing the parties’ intentions, be they actual or hypothetical. Illegality, public policy and numerous other doctrines, along with the mandatory rules of labour law, tenancy and consumer protection set such limits, for the right or wrong reasons. These doctrines are argued for in the literature in a number of different ways: third-party effects (externalities), redistribution, fairness, moralism, and paternalism are amongst the reasons.

Following Cooter and Ulen,¹⁰ I give here an overview of some regulatory doctrines of contract law. The main purpose is to identify the links between the reasons for setting limits to contractual freedom, and the typical rules that serve these reasons.

| Legal doctrine | Fact triggering legal doctrine (problem) | Incentive (solution) | Legal solution |
|----------------|--|------------------------------------|--|
| Incompetence | Incompetent person makes promise | Protect incompetents at least cost | Interpret contract in incompetent’s best interest / No enforcement |
| Duress | Promisee threatens to destroy | Deter threats | No enforcement of coerced promises |

⁹ Bigwood 2004.

¹⁰ Cooter – Ulen 2004: 294 (Table 7.5).

| | | | |
|-------------------------------|--|---|---|
| Necessity | Promisee threatens not to rescue | Reward rescue | Beneficiary pays cost of rescue plus reward |
| Impossibility | Contingency prevents performance | Encourage precaution and risk-spreading | Liability for the least-cost risk-bearer |
| Frustration of purpose | Contingency destroys purpose of performance | Encourage precaution and risk-spreading | Liability for the least-cost risk-bearer |
| Mutual mistake about facts | Buyer and seller make same mistake about facts | Encourage precaution and risk-spreading | Liability for the least-cost risk-bearer |
| Mutual mistake about identity | Buyer and seller have different object in mind | Prevent involuntary exchange | Unwind contract |
| Unilateral mistake | Buyer or seller mistaken about facts | Unite knowledge and control; encourage discovery | Enforce contract |
| Duty to disclose | Promisee harms by withholding information | Induce supply of true information | Liability for harm |
| Fraud | Promisee supplies false information knowingly | Deter supply of false information | No enforcement of contract and liability for harm |
| Adhesion contracts | Cartel uses standard forms to promote collusion | Destabilize cartels | Deny enforcement to contracts of cartels |
| Procedural unconscionability | Consumer ignorant of critical terms in retailer's contract | Create incentive to communicate meaning of contract terms | Deny enforcement unless bargaining process communicates crucial information |

Although based on American law, the information in this table can also be generalized to other legal systems. The economic reasons for intervention are essentially twofold: contracting failures and market failures. Contracting failures or problems with individual rationality are either cases of bounded rationality which is addressed by the doctrine of incapacity; or of constrained choice which is addressed as coercion, duress, necessity, or impossibility. Market failures can be explained by three types of transaction costs and addressed in contract law accordingly. First, they can be externalities which lead to the unenforceability of contracts which derogate public policy or violate a statutory duty. Second, failures deriving from imperfect information are addressed as fraud, failure to disclose, frustration of purpose, or mutual mistake. A third type is structural or situational monopoly which leads to the lack of competition, which is addressed by doctrines such as necessity, unconscionability, and lesion.¹¹ How is this categorization relevant for the discussion of paternalism?

Paternalism relates primarily to contracting failures. One can speak of paternalistic intervention mainly: (1) in the case of systematic cognitive failures or insufficient cognitive capacities; (2) when there is insufficient or asymmetric information; and (3) when there are insufficient outside opportunities, due to the circumstances of necessity or, situational or structural, monopoly.

The fact that the number of regulatory contract law doctrines in the table above is larger than the number of problems might suggest that economic theory cannot fully capture the problems the various doctrines are intended to solve. Contract regimes follow a number of goals besides correcting market failures. On the other hand, there are contract law doctrines that at first glance look paternalist as well as a number of legal instruments which, in modern legal systems typically serve paternalistic purposes. Regulators have a wide set of instruments at their disposal: formation defenses; mandatory rules and default rules; procedural (formal) requirements (formalities, cooling-off periods, information disclosure); substantive rules; rules of interpretation (construction).

¹¹ Cooter – Ulen 2004: 267.

Contract law is not the only, or the best, policy instrument in the service of paternalism, however. Economic theory suggests that some market failures should be addressed primarily through public-law-type regulation, rather than in private law. Trebilcock argues for a “relative institutional division of labor” among regulatory techniques. He suggests that the “law of contracts will be principally concerned with autonomy issues in evaluating claims of coercion, antitrust and regulatory law [with] issues of consumer welfare, and the social welfare system [with] issues of distributive justice”.¹² When we look at this carefully argued proposal by Trebilcock, it does not even mention paternalism. Is it possible to analyse or explain away paternalism in an extended law and economics approach?

I think that paternalism should indeed be considered a residual category. If we can find a (possibly implicit) reason for intervention in terms of a market failure or some third party effect, we should give priority to these, and not attribute the regulation to paternalistic purposes. Still, this strategy is mainly pragmatic and I intend to apply it only to the domain of contract law. Social burden arguments are not always relevant in terms of common moral intuitions. Similarly, there are legal areas like criminal law or medical law where market failures and externalities, if relevant at all, count as only rather weak arguments. But we should not go ahead too fast. First, the concept and justifiability of paternalism should be clarified.

Paternalism in moral and political philosophy

Without going into terminological controversies, I give a rough definition of paternalism, simply indicating how I use the term in this paper. There are three conditions for an act to be paternalistic. The paternalist (1) interferes with the subject’s liberty, (2) acts primarily out of benevolence toward the subject (i.e., his goal is to protect or promote the interests, good or welfare of the subject), and (3) acts without the consent of the subject.

If we follow this definition, paternalism has both justifiable and unjustifiable cases (forms). These cases differ with regards to their justifiability, legitimacy, or reasonableness, etc. According to the definition, paternalism implies doing something against the freedom of the subject without his consent. Under any theory which attaches value to freedom of choice, this lack of concern for the subject’s consent needs justification. Actually, paternalism provides such a *reason*: it refers to the protection or promotion of the interests (welfare or good) of the subject.

As to the justification of paternalism, the philosophical discussion is centred around three values: freedom (autonomy); welfare (interests); and benevolence. These refer to three conflicting philosophical positions: deontological, consequentialist, and perfectionist. Under the deontological (autonomy-based) view, freedom of choice is valuable because of the value of autonomy. Under the consequentialist (welfarist) view, freedom of choice is the instrument through which preferences are fulfilled. In some perfectionist (Aristotelian) views, making choices is part of being human. Looking at the extensive philosophical literature on the topic, it seems difficult to decide between the standpoints without discussing such far-reaching questions as the nature of the good, and the meaning of free will. The justification of paternalism is a complicated case

¹² Trebilcock 1993: 101.

where autonomy and welfare concerns should be balanced. In some sense, the conflict between these two values is at the core of paternalism. The divergent implications of the two basic values eventually force the philosopher to choose. But, if Dan Brock is right, on the level of theories there can be convergence.¹³ We are not forced to choose between different theories in discussing the justification of every case of paternalistic intervention. One way to avoid taking sides in far-reaching metaphysical debates is suggested by John Rawls' ideas about 'public reason' and 'overlapping consensus.'¹⁴ In this spirit, I will use arguments that can be, at a medium level of abstraction, acceptable, or at least reasonable from several comprehensive perspectives. Speaking about legal issues of more practical concern, the idea of searching for an overlapping consensus seems quite attractive and plausible. Even such a prominent figure of the law and economics movement as Richard Posner once argued for this idea as one possible basis for the general acceptance of the minimization of social costs as the objective of tort (accident) law.¹⁵ As I have argued in detail elsewhere,¹⁶ regarding the justifiability of paternalism in the limited domain of contract law, one can find an overlapping consensus among these normative conceptions. By comparing some representative versions of these philosophical perspectives, the practical conclusions drawn from the different philosophical positions turn out to be surprisingly similar.

In contrast to *philosophical* discussions, *pragmatic* arguments draw attention to the side-effects and the unintended or counter-intentional consequences of paternalistic interventions. The intervention may be more costly or harmful than beneficial, either (1) for the paternalised subject (e.g. due to the double bind effect), (2) for third parties (e.g. due to the over-inclusiveness of the legal rule), (3) or for the general public (e.g. due to implementation costs). In regards to the unintended consequences, overly protective regulation always runs the danger that certain transactions become unprofitable and lead to the collapse of the market, or the segment which was the object protection. To put it in another way, paternalism may be problematic in these cases not only because it is costly for others, but also because it might backfire, i.e. make worse off the very group of persons it intended to protect.

Paternalism in economic analysis

In this section I discuss the methodological tools economic theories offer for analyzing paternalism. I also refer to the empirical findings in psychological research on human decision making and choice behaviour which are possibly relevant for paternalism.

The traditional economic approach to freedom of contract and paternalism is a non-reflexive mixture of liberalism and utilitarianism. As such, it is ill-equipped to handle the problems which arise when these two principles collide. The potential conflict between welfare-maximization and autonomy draws attention to the non-welfarist dimension of the problem of paternalism. When this dimension is *not* taken into account, the whole problem of paternalism is reducible to a more or less

¹³ Brock 1988: 565.

¹⁴ See Rawls 1993. To be sure, in Rawls' view overlapping consensus is not simply a compromise reached by softening or mixing irreconcilable views.

¹⁵ Posner 1995: 505.

¹⁶ Cserne 2008.

sophisticated exercise in welfare-maximization. Within a strictly welfarist perspective, if the regulator knows better, he should decide in every case in the agent's place. In terms of the preceding section, the constraints to paternalism can only be pragmatic. In contrast, autonomy provides a principled constraint. As we will see, economists also take this constraint into account, at least implicitly.

In another dimension, contemporary economics is often criticized on the basis that it accepts existing preferences as given. As the critique goes, economic theory does not offer "ethical criteria for disqualifying morally offensive, self-destructive, or irrational preferences as unworthy of recognition." If, to the contrary, it acknowledges some exceptions, as it usually does (e.g. in case of minors or mentally incompetent persons) then "some theory of paternalism is required, the contours of which are not readily suggested by the private ordering paradigm itself."¹⁷ Being reluctant to criticize or "launder" preferences or rethink their model of individual choice as a combination of information (beliefs) and preferences, economists use an "eliminative redefinition" strategy in order to fit paternalism in the neoclassical models.

The economic literature on paternalism¹⁸ strives to justify instances of reasonable, seemingly paternalistic regulations in several ways which, for the sake of simplicity, can be put into four categories: market failures, merit goods, non-standard preferences and non-welfarist objectives.

The first approach sticks with consumer sovereignty and revealed preferences. Paternalism is redefined or "explained away" by showing that the policy in question serves to prevent externalities or other market failures. This strategy of eliminative redefinition does not question consumer sovereignty; arguably, this is the natural way to treat the substantive problem in economics. Indeed, at first glance it is relatively easy to incorporate paternalism in mainstream economic analysis: we just have to identify specific transaction costs and/or informational imperfections and asymmetries which lead to a market failure. In this way not only the case *for* freedom of contract, but many of its limits can be explained in relatively narrow economic terms, by neither relaxing the rationality assumptions nor recurring to fairness arguments.¹⁹ In fact, the biggest "advantage" of this approach is that the conflict between welfare and autonomy does not come to surface.

The second approach clearly and almost openly faces this conflict and solves it in favour of welfare. In the 1950s Richard Musgrave introduced two new, closely related concepts in the theory of public finance: merit wants and merit goods.²⁰ These concepts serve to formalize the welfarist idea of paternalism with regard to certain publicly provided or publicly subsidized goods. In the case of merit wants or goods, the welfare function that the policymaker has to maximize on behalf of the individuals is formally modelled in a way which is different from the way the individuals themselves (are modelled to) perceive and reveal their preferences. In other words, "consumer sovereignty" is openly questioned and abandoned in favour of a supra-individual assessment as to how much one should receive and consume of certain "merit goods". Choice is driven not by revealed preferences but by merit wants. In the case of merit

¹⁷ Trebilcock 1993: 21.

¹⁸ E.g. Burrows 1993, 1995, 1998; Saint-Paul 2004; Zamir 1998.

¹⁹ Mitchell 2002, cf. Hermalin – Katz – Craswell 2006: §2.

²⁰ For a useful introduction see the still very illuminating summary article by Head 1966.

goods, individual choice is overridden in the name of what a particular (political) community considers worthwhile for individuals to do (consume).²¹

The third category of redefinitions comprises those more or less sophisticated models of preference-formation and decision-making which introduce specific *ad hoc* assumptions about the preference structure of individuals. Examples include choice models based on path-dependent preferences, dynamic inconsistency or the multiple self. The methodological goal here is to analyze certain conflicts between autonomy and welfare with a minimal deviation from mainstream economic theory (rational choice theory). When economists analyze market behaviour, they not only implicitly rely on a standard of voluntariness but also explicitly on a standard of rationality. According to rational choice theory, weakness of will, “sour grapes” mechanisms etc. are irrational behavioural patterns. This view implies that the preferences of real-world individuals should be measured on a normative scale. The actual or revealed preference structure of individuals is compared to an ideal or rational preference structure of an abstract model construct, the rational decision-maker. Irrationality in this sense may justify intervention. One’s preferences are to be respected if they truly and consistently reflect one’s desires. But this is not always the case. The rational self can be in conflict with other features of the very same person or in other terms with different selves. These models re-conceptualize paternalism as a multiple-self problem or even as an ‘intra-personal externality’ or ‘internality’ problem. In other words, paternalism is justified when and to the extent that the limitation of freedom of choice is instrumental to the defence of the ‘true self’ of the subject against one’s weakness of will or judgment errors. Eventually, these limitations may even increase the subject’s rationality and/or autonomy.

Finally, there are such heterodox economic approaches that criticize mainstream economic theory for the reduction of every normative instance to preferences over outcomes and suggest this simplistic view be remedied. By stressing the difference between what one desires and what one has reason to value Amartya Sen belongs within this category. This distinction would move economic analysis in a perfectionist direction. Other economists (or the same ones in other writings) highlight the need for including freedom of choice in economic models.²² These lines of research can be extremely helpful for an economic analysis of the non-welfarist dimension of paternalism. Originating from Amartya Sen’s seminal article on the impossibility of a Paretian liberal,²³ there is now an emerging branch of literature in social choice theory which searches methods and modelling techniques for the incorporation of the dimension of freedom of choice into formal economic (social choice) models. The intuition behind this line of research is that the extent of opportunities, i.e. the number and diversity of alternatives open to an individual might be valuable in and of itself. The freedom to choose among alternatives might have some value independent of the intrinsic value of these alternatives.²⁴ In regards to paternalism however, this line of research has no clear and direct policy implications.

From the discussion of economic analysis of paternalism so far it has become clear that the mainstream economic approach has to face two problems. First, it remains

²¹ Musgrave 1987.

²² See, e.g. Sugden 1998, Van Hees 2002, Sen 2002.

²³ Sen 1970.

²⁴ Cf. Van Hees, 2004, Sugden 1998.

controversial from a normative point of view whether the function of law can be reduced to the maximization of individual preferences. Second, there remains a methodological difficulty: the growing amount of evidence on biases and other irrational behaviour calling the scientific fruitfulness of *ad hoc* modelling of bounded rationality into question. To put it differently: in cases where people systematically make suboptimal choices, paternalistic intervention may be justified. To determine the appropriate scope and technique of intervention, systematic empirical research on bounded rationality is necessary. However, the justification of interventions cannot be based simply on revealed individual preferences as the ultimate normative benchmark, because the concept of preference has also become questionable. Empirical research is crucial in order to answer questions about the best possible way to design legal rules, be they paternalistic or otherwise, and in the discussion of the reasons for paternalism. This implies the relevance of psychological research for law and economics, which, in fact has recently become a widely accepted branch of the discipline called, somewhat misleadingly, behavioural law and economics. Thus, whether legal policy needs empirical foundations is not a real question.²⁵ The question is rather, what will, and should, these foundations look like? In recent decades there has been a large volume of ongoing empirical research in this direction, both by psychologists and economists.²⁶ It has been shown in thorough and extensive empirical studies that human behaviour systematically deviates from the precepts of expected utility theory and rational choice theory in general.

Human decision-making, choice and judgment reaching behaviour are often characterized by loss aversion, the endowment effect and framing effects. Furthermore, people commit judgment errors when assessing probabilities. By using mental shortcuts called heuristics (availability, representativeness etc.) their judgments might become biased and vulnerable to manipulation – self-serving bias, hindsight bias, over-optimism, unstable risk-assessment being the most well-known examples.

For instance, several hundreds of studies raised fundamental doubts about the assumptions regarding preferences in economic theory. The framing effect shows that in many situations the concept of preference itself is indeterminate. In a descriptive psychological sense, the assumption that preferences are autonomous and stable is false. Several other features and mechanisms of human judgment and choice have been also described which contradict the assumptions in neoclassical economics (rational choice theory). Cognitive limits and emotional biases are ubiquitous. These should be, and have been, theoretically explained and modelled within neuro-sciences and cognitive psychology. It is important to note that in terms of these sciences, the issue is not one of biases and anomalies but the understanding of the very way human minds work.

The question to be raised is: how should law and economics (being interested in how *law* works) react to these insights? Is it possible to build a competing (and possibly superior) version of legal theory based on the analysis of these psychological phenomena? There are many obvious difficulties impeding such an endeavour. On the

²⁵ On empirical research in contract law scholarship see Korobkin 2002.

²⁶ For overview with further references see Sunstein 2000, Englerth 2004, Camerer et al. 2004, Korobkin – Ulen 2000.

whole, however, the objections usually raised against behavioural law and economics are either not convincing or not decisive in dismissing it as a line of research.²⁷

As to the policy implications of psychological research, it is clear that empirical findings alone cannot justify legal intervention. The normative implications (and policy conclusions) are not straightforward. Psychological insights suggest that the justifiability of paternalism is an “uncertain case” – outright anti-paternalism should not be replaced by uncritical paternalism.²⁸ In short, there are strong arguments both for and against paternalism. The behavioural findings may lead, in certain circumstances, to normative conclusions (policy recommendations) that are significantly different from those arising from the traditional anti-paternalism of mainstream economics. The consequences for normative analysis, however, are not simply the uncritical endorsement of paternalism. Some researchers speak about anti-anti-paternalism in this respect.

The *prima facie* arguments for paternalism seem obvious: when law can promote the interests of humans by reducing their biases, increasing their autonomy, it should. But why should the law *not* always intervene despite systematic irrationality? Besides the well-known pragmatic antipaternalist arguments (discussed above), there are numerous specific psychological arguments for not intervening in people’s choices which can complement traditional skepticism toward governmental regulation.

First, they refer to the fact that biases are highly context-dependent. We simply do not know enough about the biases to suggest a general remedy. Second, what are called “biases” in the light (or shadow) of rational choice theory are in fact (in terms of psychology) components embedded in a complex decision-making mechanism. In this complex cognitive and emotional system, there are several interactions between these mechanisms. It is possible that one bias may temper another. When such interactions are neglected, debiasing might make the overall result worse than the initial situation.

Third, learning effects can be at work. In a dynamic perspective, regulation may lead to the inhibition of learning and negatively affect rational and autonomous choice in the future. This provides a dynamic or developmental argument against paternalism.²⁹ This dynamic effect, already stressed by J. S. Mill, has been now convincingly demonstrated in empirical terms.³⁰ In my view, it provides a reason why the law should deliberately deviate from a “psychologically adequate” view of man. Arguably, if rational autonomous choice is accepted as a normative ideal, especially for contracts, then the law should counterfactually slightly “overshoot” with its assumptions concerning both of them. This should be done in order not to simply map and thus stabilize biases but to leave space for learning and development.³¹

Fourth, since biases are so varied and complex it is often the case that individuals themselves are in the best position to cope with their own irrational tendencies and

²⁷ In Cserne 2008, I discuss six objections against behavioral law and economics and the possible answers (counter-arguments), loosely based on Rachlinski 2006.

²⁸ Rachlinski 2003, Blumenthal 2007.

²⁹ Feinberg 1986: 24: “If adults are treated as children, they will in time come to be like children. Deprived of the right to choose for themselves, they will soon lose the power of rational judgment and decision. Even children, after a certain point, had better not be ‘treated as children,’ else they will never acquire the outlook and capability of responsive adults.”

³⁰ See Klick–Mitchell 2006.

³¹ Eidenmüller 2005.

deficiencies. In fact, this is what happens when people hire experts, use self-binding techniques etc. Law should encourage, or at least not crowd out these mechanisms.

New regulative ideas

In arguing for protective rules, legal commentators often refer to empirical data about the vulnerability of consumers to biases and manipulation. The psychological, pragmatic, economic and philosophical arguments, and counter-arguments, discussed in the previous section should make supporters of legal paternalism cautious. An uncritical, across-the-board support of paternalism is unwarranted. Recently, law and economics scholars have suggested a number of more or less sophisticated approaches to take into account both the behavioural insights and some of the counter-arguments. I briefly recall here three regulatory ideas: asymmetric paternalism, libertarian paternalism, and debiasing through law.

“Asymmetric paternalism”

“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.”³² More concretely, it is argued that legal interference with private choices is justified (in a firm/consumers setting) if:

$$(p * B) - [(1-p) * C] - I + d\Pi > 0,$$

where B denotes the net benefits to boundedly rational agents, C is the net costs to rational agents, I stands for the implementation costs, $d\Pi$ denotes the change in firms' profits, and p is the fraction of consumers who are boundedly rational (all other consumers are supposed to be fully rational).³³

The economists and psychologists who argue for ‘asymmetric’ paternalism on a welfarist basis also compare real-world agents with the fully rational individual as assumed in orthodox economic models. They go on to say that bounded rationality is something which can be justifiably regulated in a similar way to externalities. Here one has, first, to suppose the existence of a true ‘inner self’, characterized by such desires and beliefs which are normatively undisputed, or accepted as rational. Second, one has to explain the behavior of real world individuals as cases where their inner self falls prey to certain anomalies. As I mentioned above, one of the problems with this approach, is that it is not clear which features of the empirical self should be respected and protected.

Asymmetric paternalism is a purely consequentialist argument. As such, it is open to criticisms for not taking autonomy seriously. Read in a different way, this formula only illustrates the structure of the problem of legal paternalism. It does not serve to measure and quantify these variables, but to highlight who are the beneficiaries, and who are the cost bearers of a paternalistic intervention. These costs and benefits can be more precisely assessed in specific contexts.

³² Camerer et al. 2003: 1219.

³³ Camerer et al. 2003: 1219.

“Libertarian paternalism”

While “asymmetric paternalism” suggests policies that protect boundedly rational individuals while not (significantly) burdening others who do not need protection, “libertarian paternalism” draws attention to the different methods and techniques of this protection. More precisely, “libertarian paternalism” suggests policies that respect the autonomy of boundedly rational people to the extent possible, but nevertheless help them to avoid making bad choices.³⁴ It advocates paternalistic interventions mainly in the form of default rules and “menus.” As we will see, contract law is the legal area *par excellence* where even non-mandatory rules can improve the welfare of the parties.

“Debiasing through law”

Still another regulatory ideal, suggested by Christine Jolls and Cass Sunstein is more ambitious.³⁵ Instead of searching for legal rules which are adaptive to judgment and decision errors, it aims to reduce the occurrence of boundedly rational behavior at the first place. In addition, the novelty of this view is to suggest debiasing be achieved by exploiting (or at least relying on) bounded rationality itself. As already mentioned, psychologists have found several instances where biases interact, and more specifically, offset each other. In these cases, an intervention aimed at the reduction of only one of the biases can actually worsen the overall result. Now, the interaction between compensating biases may be deliberately designed and used by policymakers as well. Jolls and Sunstein illustrate, with examples from various legal areas, how legislators can make use of the presence of one psychological mechanism (e.g. the availability heuristic) in order to counteract the self-detrimental effects of another (e.g. over-optimism). One of their examples is consumer safety law.³⁶

It is a well-established fact that consumers are asymmetrically uninformed about the safety features of most of the products they purchase. Mandatory disclosure requirements are a wide-spread legislative response to this kind of informational asymmetry, both in the United States and in Europe.³⁷ In principle, this is a preferable way of intervention, as information provision respects individual choice. In practice, disclosure does not necessarily work well. One reason for this is that people do not process the information in a rational way. Not only that they deviate from Bayesian theory. Even if their understanding (estimations) of the general risk probabilities is correct in a statistical sense, they are overly optimistic about the occurrence of safety risks in their own specific case. In the psychological literature this is called over-optimism bias. The idea of debiasing through law is to remedy this bias by making use of another, the availability heuristic. By using vivid and personified examples, the tendency towards underestimation of personal risks can be compensated. If people are confronted by a story about a recent real-life case of harm caused by a defective product, they become more aware or even overly aware of the risks involved.

To be sure, this rudimentary idea of debiasing through law should be refined in many ways before making actual use of it in information regulation. Even if the

³⁴ Thaler – Sunstein 2003, Sunstein – Thaler 2003. For a restatement of their view see Thaler – Sunstein 2006.

³⁵ Jolls – Sunstein 2006.

³⁶ Jolls – Sunstein 2006: 215.

³⁷ See e.g. Grundmann – Kerber – Weatherhill 2001.

psychological argument is sound, a traditional legal scholar would definitely have a large number of doctrinal and systemic arguments as to why the idea cannot be easily put in legal form.³⁸

This brings us back to the core questions of this workshop: how, and to what extent can philosophical, economic, and psychological arguments be “imported” in legal discourses? Before answering this question directly, I should say a bit more about the methodological premises (assumptions, commitments) of the extended law and economics approach I am arguing for. Elaborating on these issues in the following section will hopefully provide some more general methodological lessons as well.

Methodological lessons

In my view, in order to assess the problems of paternalism in contract law properly, an empirically based policy-oriented view is both fruitful and necessary. More generally, legal scholarship should take into account not only practical philosophy, but insights from both economic theory and empirical research as well.

Economists learning from law?

Specifically and succinctly, lawyers can, and should, learn from both economics and psychology. Or is it the other way around? Interestingly, Robert Cooter and Thomas Ulen, two eminent law and economics scholars suggest that this learning should *also* work the other way around. Economists should learn from law, most notably contract law. In the introductory chapter of what is probably the most popular textbook on the subject, they write: “*Economists frequently extol the virtues of voluntary exchange, but economics does not have a detailed account of what it means for an exchange to be voluntary. [...] Contract law has a complex well-articulated theory of volition. If economists will listen to what the law has to teach them, they will find their models being drawn closer to reality.*”³⁹

Although these sentences have been reprinted in the book several times since 1988, they seem to have elicited little formal comment. Nevertheless, their claim is far from trivial. In this statement Cooter and Ulen argue here for a kind of import; if not from jurisprudence, at least from the law. In my view, even if this gesture of two economists towards lawyers is to be appreciated, it cannot be taken at face value. The “theory of volition” of contract law, well-articulated as it may be, is not well-founded theoretically.⁴⁰ In the law, this generally seems to be the case. Legal rules and doctrines doubtlessly often reflect practical rationality and offer at the level of folk psychology an intuitively appealing shortcut to endless philosophical debates. For instance, in many legal systems there is a close-to-ordinary-language or doctrinal-technical legal meaning to concepts like voluntariness, intent, or causation – the former interpretation typically characterizes the Common law, the latter Continental legal rules. These legal concepts

³⁸ Cf. Aaken 2006.

³⁹ Cooter – Ulen 2004: 11.

⁴⁰ Another problem is that, important overlaps notwithstanding, there are as many “theories of volition” as national (as well as infra- and supranational) contract laws.

usually half-knowingly reflect philosophical or scientific standpoints of earlier ages⁴¹ or just express some folk-psychological notions. For the everyday working of law as a practical enterprise these naive or common sense theories are fully satisfactory, at least in the so called ‘easy cases’. But what the law says about voluntariness, causation etc. can be called a “theory” only in this “practical” sense.⁴²

A further difficulty is that this “legal world view” is not of much help in policy design. It is impossible, for instance, to answer from a purely legal perspective how the legally required degree of voluntariness of contract formation, or the criteria for the judicial control of standard form contracts *should* be reasonably regulated. If we want to understand and/or criticize the rationale behind legal rules, then what law regulates in this or that way has to be analyzed and evaluated from an outside perspective, i.e. from a not strictly *legal* point of view.

Interdisciplinarity

Regarding the proper methods and scope of such a non-doctrinal analysis of legal issues, many methodological questions can be raised. Here, mention will only be made of a couple of points which help elucidate the methodological stance taken in this work.⁴³

The reason why legal policy should be informed by empirical and theoretical research on human decision making and judgment is mainly instrumental. This information makes it possible to systematically predict the consequences of legal rules, and their alteration. Here, both economic and psychological insights are highly relevant.⁴⁴

In modern societies law is often conceived of as a means to various policy ends. On the other hand, it is also understood as a system of institutional actions performed in the name of ‘the law’. To the extent that legal discourse is formally rational, it has some autonomy that does not allow for the direct codification or application of any normative philosophy or the results of empirical research *in law* or *as law*.⁴⁵ In this sense, ‘the law’ is a specialized practical activity rather than a political or academic, i.e. scientific, or philosophical discussion.

An important implication of this is that ‘the law’ as a practice cannot be suspended until the best theoretical solutions are found. Since time constraints are strict, resources, including expertise, are limited, and experimentation is exceptional,

⁴¹ “[T]he metaphysics of the Stone Age” (Hart – Honoré 1985: 2). These authors do not share the critique implied by the term.

⁴² For a classical analysis of causation from an “ordinary language philosophy” perspective see Hart – Honoré 1985. The rather innocent quote by Cooter and Ulen raises important jurisprudential and philosophical questions. The relations between folk psychology, legal epistemology and scientific knowledge are a fascinating research topic but it is beyond the scope of this work.

⁴³ These questions are discussed extensively in the German-speaking law and economics literature. See e.g. Behrens 1986, Eidenmüller 1995, Aaken 2003.

⁴⁴ This does not imply that law should have a “psychologically adequate” view of man. As I have mentioned above, there can be reasons for the law to deliberately deviate from such a “psychologically adequate” view.

⁴⁵ On legal formalism see Kennedy 1973, 1976. Theorists like Luhmann and Teubner represent some version of this idea.

pragmatism and simple rules are used and needed.⁴⁶ In legislation and, to an even larger extent in adjudication, the use of external knowledge is limited by both systemic and practical considerations.

As to the incorporation of interdisciplinary knowledge in the theoretical understanding or analysis of law, these practical limits are irrelevant. On the other hand, whether the findings of (behavioural) economics are as relevant for jurisprudence proper, as for legal policy, is not straightforward. Much depends on the self-understanding (definition, purpose, methods) of legal scholarship itself.⁴⁷

In this respect, I can only note a few points here. Economic, psychological, sociological etc. analyses of law are legitimate theoretical approaches. They provide insights to law from an external point of view. While such analyses do not *replace* doctrinal argumentation which has important separate functions to fulfil in a complex modern legal system, they interact with it in a number of ways. For the purposes of this thesis one of these ways is especially relevant: economics, psychology, philosophy help scholars who criticize and improve legal rules and doctrines through policy recommendations.⁴⁸

As I have argued, various factors place limits upon the *direct* usefulness of philosophy, economics and psychology in the development of legal policy and in jurisprudence. It is important to note however, that the proper role of economic and other non-legal insights in adjudication, or legal decision-making in general, cannot be determined generally: rather, it depends on a number of characteristics of legal decision-making (linked to various issues like discretion, expertise and legitimacy). Particular legal cultures (Continental, common law, and non-Western), national legal systems, or even legal areas (private law, administrative law, and criminal law) differ crucially along these dimensions. An important sub-question in this context concerns the role of consequentialist reasoning, especially that of economic analysis in legal decision making.⁴⁹

In various legal systems and in different legal areas, this role is considered to be different. As noted above, law as a practical institution needs, and has, some autonomy. One should avoid “the jurisprudential naïveté about the ultimate connection, if any, between [...] economic analysis and the sort of argument that might be acceptable to courts.”⁵⁰ This idea suggests that the direct impact of economic analysis on adjudication depends on the *canon of arguments* considered legitimate or acceptable within a particular legal system or legal area.⁵¹ This reasoning applies to contracts and torts in common law as well. As Richard Craswell had argued, “it is appropriate to regard each economic analysis as being limited by the preface” which makes clear that the particular efficiency arguments of the analysis should be considered by judges *to the extent*

⁴⁶ There are various normative legal theories arguing for “simple rules”, see e.g. Epstein 2006.

⁴⁷ As Peter Behrens convincingly argues, the methodological self-understanding of “legal science” (*Rechtswissenschaft*) and economics has a crucial impact on the possible ways of their cooperation and the perspectives of interdisciplinary research on law and the economy (Behrens 1986: 6–30).

⁴⁸ Roughly, this is the way Hans Albert conceives jurisprudence. See e.g. Albert 1972, 1986, 1992, 1993.

⁴⁹ On the role of consequentialist arguments in adjudication see e.g. Wälde 1979, Deckert 1995, Cane 2000. For two opposing views on the role of efficiency arguments in (German) law see Eidenmüller 1995: part IV, Kötz – Schäfer 2003: vi–viii.

⁵⁰ Craswell 1993: 293.

⁵¹ On the “canon of acceptable arguments” see Honoré 1973: 64–66.

*prudential arguments are relevant.*⁵² In brief, economic analysis is relevant in adjudication if and when prudential arguments in general are relevant.

To be sure, policy arguments are not necessarily addressed to judges. In other, non-judicial arenas other “canons of acceptable arguments” operate. As I argue below, for the issue of paternalism in contract law, the arena of legal policy is of primary relevance. Concerning the role of economic analysis in legal policy, it may be said it is both *vindicated* and *limited* by the following meta-criterion. “[E]conomic analysis can claim that its reasons justify outcomes because of the role the principle of efficiency plays in the overall set of institutions sanctioned by the normative political theory justifying political authority.”⁵³

To sum it up, while interdisciplinarity does not imply that lawyers should become economists, psychologists or philosophers, they should nevertheless rely both on a transparent normative theory about the goals to be achieved through law, and on empirical research about, and a theory of, human behaviour facilitated and regulated by law. In the complex interrelations of empirical research, theoretical models and philosophical questions, multilateral translation and learning seem not only fruitful but necessary. In my particular subject, the need for “multilateral translation” is almost obvious, for a simple reason. Paternalism is a *philosophical* concept which is used in the analysis of *legal* problems with the tools of *economics*.

The policy perspective

Roughly speaking, one can distinguish three different discourses in which arguments from law and economics can be relevant. It can be conceived as a (consequentialist) normative legal philosophy; as an explanatory theory of law (rational choice theory applied to law); and as a set of propositions for legal reform (legal policy).

In the first branch, what I mean by law and economics as legal philosophy is a normative analysis dealing mainly with questions regarding the justifiability of adopting efficiency as the main guiding principle of law.⁵⁴ In the second, explanatory branch, law and economics seeks either to explain how law influences human behavior by changing incentives (law as *explanans*), or to analyze legal, and possibly non-legal, rules as the outcome of interactions between rational individuals (law as *explanandum*). The emergence and change of legal rules and doctrines are the subject matter of “positive political economy” or public choice theory. Finally, by law and economics as legal policy it is meant: a more or less coherent system of proposals for reforming legal rules in order to fulfill certain given or hypothetical normative criteria, among which efficiency has primary importance.

As with categorizations usually, this one is useful if it helps systematize our arguments. Thus the main research questions addressed by the thesis can be grouped into three categories which correspond to the three levels of economic analysis.

(1) Conceptual and normative questions. What does paternalism mean? Is it justified to limit someone’s freedom in order to promote his interests? If so, in which

⁵² Craswell 1993: 292–293.

⁵³ Kraus 2006: 15.

⁵⁴ For book-length arguments for efficiency in this respect see Posner 1981, Kaplow – Shavell 2002. For discussion and criticism see the still informative collection of articles in Symposium 1980, especially Kornhauser 1980.

cases, to what extent and, by whom? Why and to what extent do we need freedom of contract? What are legitimate reasons for interfering with contracts?

(2) Empirical questions. Do people generally, and in given contexts, choose rationally? Do they evaluate risks correctly? How do they process the information available to them? How do individuals (consumers) and legal entities (firms) react to different regulations? What are the side-effects and possible non-intended consequences of contract regulation?

(3) Policy questions. Assuming sub-optimal contracts may occur, should the law interfere with contractual agreements in which one party was not fully informed, or not fully rational? If so, which instruments would be most applicable to achieve this? What are the legal, political and other institutions or mechanisms most suitable in any given case?

Obviously, the questions raised on each of these levels are linked to each other. Most importantly, the third level of analysis relies on both the first and the second levels. As legal policy refers to a more or less coherent system of proposals for reforming or interpreting legal rules, the basic idea behind such proposals is that the law should fulfill certain, either hypothetically or tacitly accepted, normative criteria. In the law and economics literature, Pareto or, more often, Kaldor–Hicks, efficiency is the most important of these criteria.⁵⁵ In this work, the analysis is based on arguments regarding the justification of certain instances of paternalism, and some empirical facts or hypotheses concerning the effects of freedom of choice and legal intervention. These are combined in order to contribute to a legal policy discourse regarding the possible legal means for achieving certain normative goals in an effective way.

Extending standard methods

In the quote above Cooter and Ulen also suggest, rightly, that sometimes legal problems draw attention to highly important questions, to which standard economic analysis does not offer any well-developed answer. Arguably, the meaning and value of freedom of choice and the arguments for or against paternalism are such questions. This observation raises the methodological question, whether and how the traditional economic arguments against paternalism and for freedom of contract should be reassessed in light of recent empirical and theoretical studies. If Cooter and Ulen are right, then law and economics scholars should be open to insights coming from elsewhere. While the methodological starting point of policy-oriented legal research should be rational choice theory, as applied in the law and economics literature, limitations, corrections and extensions to this approach should be taken into account.⁵⁶

As we have seen, the standard law and economics literature usually rejects paternalism as a bad reason for limiting freedom of contract. This view is not, however, strongly nor coherently argued. First, it largely fails to take into account relevant

⁵⁵ A social arrangement (the allocation of resources) is Pareto-efficient if reallocation can make nobody better off without making somebody worse off than in the status quo. When it is possible to make at least one person better off without making anybody worse off, we speak about a Pareto improvement. In contrast, a change is called potential Pareto improvement if the winners' gains from the change are higher than the losses of the losers, so that the former are capable to compensate the latter. Such changes are also called Kaldor–Hicks improvement. For technically precise definitions and refinements see Zerbe 2001.

⁵⁶ On rational choice theory in law and economics see Ulen 2000.

empirical facts about contracting behaviour. Second, it generally uses a strange mixture of liberal and utilitarian (welfarist) arguments without reflecting about their relationship. As I have illustrated, the tools recently developed within two branches of economic theory can contribute to an approach to paternalism which is simultaneously more coherent and richer in nuances than the traditional law and economics perspective. By reconsidering standard economic arguments and confronting them with psychological, philosophical and jurisprudential considerations, I suggest enriching and modifying the traditional law and economics arguments about paternalism in two main ways. The first way is to incorporate the empirical findings of behavioural decision theory which offer a more realistic view of the situations susceptible for paternalistic intervention. The second is to take into account insights from the analysis of freedom of choice in social choice theory concerning the possibility to include the non-welfarist dimension of the subject in economic analysis.

Instead of discussing the benefits and methodological difficulties of incorporating these ideas, methods and results in legal scholarship *in abstracto*, these questions should be dealt in the context of specific issues. Here I merely note that these methodological extensions have consequences for all three levels or types of legal discourse. On the level of normative political and legal philosophy the problem of autonomy makes economic theories on freedom of choice and a non-instrumental analysis of opportunities relevant. On the level of explanatory social science the empirical results and theoretical constructs of psychology come into play. Finally, the level of legal policy should rely both on the two other levels and, in order to avoid *naïveté* or the accusation of being dictatorial, it has to take into account the politico-institutional framework within which the legal policymaking of a modern democracy operates.⁵⁷

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⁵⁷ Cf. how James Gordley concludes his paper on paternalism in contract law: "This Essay may have disappointed the reader because it does not attempt to prove which particular voluntary agreements the state should prohibit, require, encourage, discourage, or fund. If those issues were subject to proof, academics should rule the world. In our society, such decisions must be left to the prudence of the citizens, to that of leaders whom one hopes are prudently elected, and subject to constitutional constraints that one hopes are prudently imposed. That is one might expect in a representative democracy." (Gordley 2007: 1772) While I do not fundamentally disagree with this, at an earlier stage in my career I allow myself to be somewhat more trustful in academics and the role of proofs.

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