

Swarthmore College

## Works

---

Economics Faculty Works

Economics

---

2003

### Review Of "Economic Efficiency In Law And Economics" By R.O. Zerbe

Mark Kuperberg

Swarthmore College, mkuperb1@swarthmore.edu

Follow this and additional works at: <https://works.swarthmore.edu/fac-economics>



Part of the Economics Commons

Let us know how access to these works benefits you

---

#### Recommended Citation

Mark Kuperberg. (2003). "Review Of "Economic Efficiency In Law And Economics" By R.O. Zerbe". *Journal Of Economic Literature*. Volume 41, Issue 1. 222-223.

<https://works.swarthmore.edu/fac-economics/21>

An [accessible version](#) of this publication has been made available courtesy of Swarthmore College Libraries. For further accessibility assistance, please contact [openaccess@swarthmore.edu](mailto:openaccess@swarthmore.edu) with the title or URL of any relevant works.

This work is brought to you for free by Swarthmore College Libraries' Works. It has been accepted for inclusion in Economics Faculty Works by an authorized administrator of Works. For more information, please contact [myworks@swarthmore.edu](mailto:myworks@swarthmore.edu).

Review

Reviewed Work(s): Economic Efficiency in Law and Economics by Richard O. Zerbe,

Review by: Mark Kuperberg

Source: *Journal of Economic Literature*, Vol. 41, No. 1 (Mar., 2003), pp. 222-223

Published by: American Economic Association

Stable URL: <http://www.jstor.org/stable/3217403>

Accessed: 21-09-2017 15:58 UTC

---

JSTOR is a not-for-profit service that helps scholars, researchers, and students discover, use, and build upon a wide range of content in a trusted digital archive. We use information technology and tools to increase productivity and facilitate new forms of scholarship. For more information about JSTOR, please contact [support@jstor.org](mailto:support@jstor.org).

Your use of the JSTOR archive indicates your acceptance of the Terms & Conditions of Use, available at <http://about.jstor.org/terms>



JSTOR

*American Economic Association* is collaborating with JSTOR to digitize, preserve and extend access to *Journal of Economic Literature*

construction may be a reaction to individualistic rational choice theory. Now human cognition does not make us very good natural logicians or natural statisticians, but we are remarkably effective at making sense by making patterns, and we are usually strongly motivated to create patterns and use them as a basis for action (economists as much as any group); moreover, the similarity between human brains facilitates the adoption of other people's patterns to supplement our own—for individual comprehension even before co-ordination.

White neglects Knight's observation that we group phenomena by similarities while ignoring differences that are deemed irrelevant. Now, as Popper observed, any such grouping implies a point of view, and points of view may differ. Adam Smith realized that the division of labor encouraged a variety of viewpoints, thus making better use of our collective capacity for pattern making. Different contexts of similarity produce different interpretative systems, cultures and subcultures, on which White relies—and also disputed interpretations, paradigm shifts, and misguided consensus such as the vision of the telecoms market that produced the history of WorldCom and its peers; within a market they may produce the developing capabilities and perceptions of productive opportunities that characterize a Penrosian firm, and so explain, as White does not, the alignment of firms with market niches. A treatment of capabilities, including transaction capabilities (on which Mark Casson has focused) is a natural complement to White's scheme.

The selective connections in that scheme find a natural complement in the selective connections that constitute knowledge—and it is knowledge that orders information. Knowledge is conjecture and therefore provisional; its reliability is a crucial issue for the effectiveness and durability of any of the markets discussed by White. It is notable that Ziman (1978, *Reliable Knowledge*, Cambridge: Cambridge University Press; 2000, *Real Science*, Cambridge: Cambridge University Press), in appraising the reliability of scientific knowledge, links human cognition to intersubjectivity and consensibility, and emphasizes the importance of structures, norms, commitment, and processes, thus providing both similarities and contrasts to the operation of markets. White's production markets are a form of organi-

zation that aids knowledge (though subject to errors both great and small).

We act on the basis of representations; to analyze the actions of others we construct representations of their representations. White is well aware of this, and organizes his discussion and designs his models accordingly. Both deserve careful consideration and a fair trial.

BRIAN J. LOASBY

*University of Stirling*

*Economic Efficiency in Law and Economics*. By Richard O. Zerbe, Jr. Cheltenham, U.K., and Northampton, Mass.: Elgar; distributed by American International Distribution Corporation, Williston, Vt., 2001. Pp. v, 328. \$95.00, cloth; \$35.00, paper. ISBN 1-84064-301-3, cloth; 1-84064-611-X, pbk. *JEL 2002-0046*

This is a very ambitious book with a rather unpretentious title. The reader gets some inkling that this is no garden variety law and economics text when Zerbe introduces the concept of KHZ efficiency, as in Kaldor-Hicks-Zerbe efficiency. KHZ efficiency is the central organizing concept of the book, and the book's worth stands or falls on the usefulness of this concept.

Before exploring KHZ efficiency in depth, Zerbe has a nice discussion of the distinctions between equivalent variation, compensating variation, willingness to pay, and willingness to accept, and a detailed analysis of the strengths and weaknesses of the Kaldor-Hicks concept of efficiency. Zerbe also makes a useful distinction between transaction costs that relate to changing legal rules and transaction costs that relate to the transfer of entitlements under existing legal rules. Only the latter count in determining whether an existing legal rule is efficient. That is, a legal rule is inefficient if there exists an alternative rule which will more likely result in entitlements going to higher valued users. It is irrelevant for this determination if transaction costs prevent this alternative rule from being adopted. This is important because otherwise all existing legal rules would be efficient tautologically.

As for KHZ efficiency, it is Kaldor-Hicks efficiency writ large, *very large*. The underlying premise is that anything that anyone is willing to pay for should be considered a good, and that the appropriate cost-benefit analysis is one that sums up willingness to pay for all of these "goods." This seemingly simple premise resolves in a formal

way many of the conundrums that bedevil cost-benefit analysis and law and economics. It is the ultimate working out of the tradition in law and economics that Richard Posner called “wealth maximization.”

For example, should compensation be paid to losers or is the potential to pay compensation, as in Kaldor-Hicks, sufficient for a change to pass the cost-benefit test? The answer for Zerbe depends upon whether the population as a whole has a positive willingness to pay compensation to losers. If the population is willing to pay for a compensation system, then paying compensation is KHZ efficient and not paying compensation would be KHZ inefficient. Zerbe puts such feelings, backed by dollars, into a category called “regard for others.”

The “regard for others” category, however, has much wider implications than resolving the compensation conundrum. Consider the difficulty presented for wealth maximization by the fact that some people are willing to pay for the right to commit bad acts. According to KHZ, the efficiency of prohibiting such acts depends upon the culprit’s willingness to pay versus the victim and everyone else’s need to accept payment. Zerbe rightly notes that bad acts are less likely to pass a KHZ test than a traditional cost-benefit test since everyone, and not just the victim, gets to weigh in on the question.

But, what about acts that some people consider bad and others do not—such as homosexuality? Well, that also gets put up for a KHZ vote. So, if more people are willing to pay to prohibit homosexual acts than homosexuals and civil libertarians need to be paid to accept such a prohibition, then homosexuality is inefficient. As Zerbe notes, KHZ efficiency is completely dependent on the population’s values—it is not an independent standard of what is right. KHZ is only as moral as the sentiments of the people.

Zerbe claims that the strength of KHZ is its practicality in that it provides a mechanism to decide what the society wants. It aspires to no greater claim of objective truth than this. Yet, one can question whether such a wide-ranging survey of everyone’s willingness to pay is practicable. One virtue of traditional cost-benefit analysis is that by limiting the calculations to those immediately affected by a project, it limits the universe of sentiments that must be sampled.

Aside from practicality, KHZ and wealth maximization are morally and theoretically problem-

atic in that it is questionable whether any system with so little *a priori* input can ever give satisfactory answers. At a theoretical level, general equilibrium theory takes endowments (or entitlements) as given *a priori*, and trade proceeds from there. General equilibrium theory does not attempt to bootstrap the distribution of endowments from within itself.

In a related point, Zerbe claims that KHZ efficiency does not suffer from the Scitovsky Paradox, but this is unlikely. KHZ, after all, is simply a voting system where votes are weighted by willingness to pay. As such, it cannot escape Arrow’s Impossibility Theorem, and intransitivities are likely to arise. “Regard for others” exacerbates this problem. One need get no more technical than the “Gift of the Magi” to realize the paradoxes that can emerge when I am willing to pay to make you happy and you are willing to pay to make me happy.

While Zerbe does not claim that KHZ is a moral system, “regard for others” has the potential to ride roughshod over any sense of individual autonomy. Under KHZ, I have no more right to determine what I may do than others have in determining what I may do. The only constraint on “busy-body” tastes is that the busy bodies may be too cheap to pay for their tastes. Clearly, the system could be improved by reasonable *a priori* limits on what tastes can count.

MARK KUPERBERG

*Swarthmore College*

## E Macroeconomics and Monetary Economics

*Financial Policy and Central Banking in Japan.*

By Thomas F. Cargill, Michael M. Hutchison, and Takatoshi Ito. Cambridge and London: MIT Press, 2000. Pp. viii, 196. \$27.95. ISBN 0-262-03285-6. JEL 2001-0977

This book is the sequel to the authors’ 1997 book, *The Political Economy of Japanese Monetary Policy* (MIT Press), which examined the development of the central banking and financial system in Japan from the 1950s to the 1990s. The authors started working on this sequel shortly before the publication of the first book. They knew that the new Bank of Japan Act would be implemented in April 1998, and planned to analyze the impact of the institutional reform on monetary