

# **Freedom of choice and paternalism in contract law: a *law and economics* perspective**

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## **Abstract:**

*This paper is a preliminary discussion of some theoretical and methodological issues related to my PhD thesis. The topic of the dissertation can be succinctly formulated as the legal and economic analysis of paternalism in contract law. I got interested in this problematic when reading M. J. Trebilcock's book (The limits of freedom of contract, 1993) and writing a review article on it, and earlier still when I wrote a paper on the economic analysis of Hungarian and European occupational safety regulation of the work with display screen equipment.*

*The topic raises conceptual and normative issues in political philosophy, and legal policy questions in contract law. Methodologically, my purpose is to analyse whether the traditional economic arguments against paternalism and for freedom of contract remain valid if, following behavioural decision theory we assume that not only (at least one of) the contracting individuals but also the legislator/regulator is imperfectly rational or not fully informed. That is, whether we have to modify the traditional anti-paternalism of law and economics for anti-anti-paternalism: a limited and critical version of paternalism. In the thesis, beyond philosophical and jurisprudential considerations, I analyse and criticise some pieces of contract law legislation in this respect.*

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## 1. Introduction

In the introductory chapter of the leading American law and economics textbook we read: “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. As we shall see, 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.”<sup>1</sup>

Even if this gesture of two economists towards lawyers is to be appreciated, it cannot be taken fully seriously as it stands. Jurisprudence and legal doctrines may doubtlessly often reflect practical rationality and offer at the level of folk psychology an intuitively appealing shortcut to endless philosophical debates. More precisely there is some close-to-ordinary-language (English) or dogmatic-technical (Continental) legal meaning of voluntariness, causation, intent, etc. which usually reflects the philosophical or scientific standpoint of earlier ages or is just expressing some naïve, folk notions.<sup>2</sup> For law as a practical enterprise this is, in principle, fully satisfactory.

Still, what law regulates in this or that way has to be critically examined and evaluated from an outside perspective, i.e. from a not strictly legal point of view, if we want to understand and/or criticize legal rules. For instance, it is impossible to answer from a purely legal perspective whether it is reasonable to regulate the legally required degree of voluntariness of contract formation in this or that way.<sup>3</sup>

The problem motivating my research is how economic analysis can face this challenge posed by the law. However, if Cooter and Ulen are right to say that traditional economics (and thus standard *law and economics*) does not offer any well-developed answer to such questions, we should possibly look for them elsewhere.

The voluntariness of contracts is related to the meaning and value of freedom of choice and the arguments for or against paternalism. The question of freedom of choice and its limits play, often implicitly, a crucial role in contract law. For instance, the validity of a contract, liability and remedies are often conditional on the (in)voluntariness of one party’s action. There are also several typical cases or rather whole bodies of rules in modern legal regimes setting limits to the general principle of freedom of contract, for good or wrong reasons (labour law, consumer protection etc.). One of these reasons is paternalism.

Since J. S. Mill’s ideas of about the limits of state power and the harm principle as the only justification for the use of coercion against competent individuals has become widespread in the Western world, paternalism has been a central problem of legal and political theory. The moral (ethical) interest of paternalism comes from the juxtaposition of freedom and benevolence (the autonomy and the good of the individual). Paternalism is problematic from the liberal point of view as it implies

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<sup>1</sup> Cooter - Ulen 2004, 11.

<sup>2</sup> See, e. g. Hart – Honoré 1985, Watson 1974.

<sup>3</sup> This is especially true for the contract doctrines expressed in most of the civil codes in Europe, dating from the 19<sup>th</sup> century when legal scholars deliberately worked out their doctrinal constructions, both in civil law and common law countries as markedly ‘legal’ doctrines, i.e. independently of philosophical theories. More specifically, as James Gordley has convincingly reconstructed (see Gordley 1991), the Aristotelian and Thomistic philosophical theories which gave a coherent theoretical structure to contract law (and other areas of private law as well) from the 16<sup>th</sup> century on, have gone to disrepute and oblivion in later centuries but there haven’t been any overarching alternative theory at hand to replace them, thus the fragmentary and heterogeneous ‘legal’ doctrines of the last two centuries.

promoting the good of a person against his (free) will. More precisely, the problems are both conceptual and normative. As we shall see, one of the conceptual problems is to determine what free will in a specific context means, as there is no self-evident reference point or threshold. As for justification, paternalism is not such an essentially condemnable thing as murder: in a formal sense it is rather like killing which has both justified and unjustified cases. In contract law the arguments for or against paternalism have to deal with some additional specificities, as we shall see below.

Needless to say, both freedom of contract and paternalism have been discussed in economics for some time, though the systematic analysis of the problematic is relatively recent. The standard *law and economics* literature usually views paternalism as a wrong reason for limiting freedom of contract. This, however, is not a strongly and coherently argued view. It generally uses a strange mixture of liberal and utilitarian (welfarist) arguments and relies on some questionable implicit empirical claims as well.

In this paper I argue that the tools recently developed within two branches of economics can contribute to a more coherent perspective on the question of freedom of contract and paternalism than we currently have. By reconsidering the standard economic arguments and confronting them with philosophical and jurisprudential considerations, I suggest modifying the traditional *law and economics* arguments about paternalism in two ways: (1) the empirical findings of behavioural economics offer a more realistic view of the situations susceptible for paternalistic intervention, (2) the analytical tools of the freedom of choice literature help to clarify the non-welfarist dimension of the problem. Then, in light of these theoretical findings, it is possible to analyse and criticise in detail some contract law rules and doctrines that at first glance look paternalist. By way of illustration, I shall briefly mention some of these in the last part of the paper.

The paper deals with conceptual, empirical and normative issues as well. In the following three sections I discuss *some aspects of* these questions:

1. What does paternalism mean? Is it justified to limit one's individual freedom in order to promote his good? How and when and by whom?
2. Do people generally choose rationally? Do they evaluate risks correctly? How do they process the information available for them? Are there legal or political institutions that are more suitable to evaluate certain types of risk? How do individuals (consumers, firms) react to different regulations, what are the side-effects and possible non-intended consequences?
3. Should contract law interfere with not fully-informed or not fully-rational contracts for this reason? What are the possible instruments for that? Which contract law doctrines serve legitimate paternalistic purposes?

## **2. Paternalism and freedom of contract – conceptual and justificatory issues**

Besides paternalistic individual actions, cases of legal paternalism abound: from medical law (doctor – patient relationship), drug prohibition, occupational safety and health regulation to the mandatory waiting time before marriage and the general irrelevance of consent to mutilation and homicide on part of the victim in criminal law. Sometimes paternalism can be an issue in a very subtle way, e.g. when it is about transfer of information and true or false believes. E.g. can a physician waive responsibility for the harm to his patient if she refuses or chooses certain treatment just because she does not want to hear and accept or believe the information, given to her by

the doctor? How much is the doctor obliged and allowed to convince, persuade, press and coerce the patient to have or not to have a certain therapy? Nevertheless, paternalism is relatively specific phenomenon. So we should beware of the indiscriminate use of the term for every limitation of freedom of choice.

## 2.1. Problems of definition

It is not only for the intrinsic interest of philosophical issues<sup>4</sup> that I do not jump over the conceptual problem of defining paternalism and directly focus on a more doctrinal or empirical analysis. It is rather the case that it would be almost impossible to do that. Both freedom and paternalism are ‘essentially contested concepts’, it is impossible to find the clear boundaries or conceptual features around which there would be a reasonable degree of consent in the literature. Even if we put in brackets the intricacies of highly abstract philosophical distinctions, it is not easy to determine what we should mean by paternalism *in law*. Although intuitively we can determine a large number of regulations which seem paternalistic, the term itself hardly ever figures in legal texts or commentaries.<sup>5</sup> Thus we cannot avoid recurring to some extra-legal definition of the term, and then using it in order to circumscribe the field we have to deal with.

It is essential to see that in a given instance several principles are or could be in play. The possible overarching theoretical systems behind more specific reasons for intervention and also the possible justifications of a concrete rule are multiple. It is e.g. often argued that to justify the compulsory use of safety helmets or the ban on tobacco advertisements, it is fully sufficient to refer to the social burdens caused by accidents and tobacco-related medical costs and thereby the ‘dubious’ arguments about autonomy, coercion etc. can be avoided. In contemporary European countries with universal (i.e. nationwide and compulsory) social security systems, we can allegedly avoid to refer to paternalism in order to justify the prohibition of certain self-harming behaviours and can “simply” refer to the external effects, i.e. the financial burdens that a given action would cause – provided self-inflicted harms are not excluded from the coverage of social security.

But it is easily possible that in pure social expense terms these paternalistic rules are counter-effective. While certain accidents without safety helmet often cause death, helmets usually save “only” the life of a severely disabled person. Without smoking people live longer on average, thus using more social funds (mainly in form of pension) than smokers who die relatively early. Not mentioning that these effects are probably not workable as ‘public reasons’ in the Rawlsian sense<sup>6</sup>, they are still remarkable from an economic perspective. If we don’t want the arguments about paternalism to run fully against our intuitions, we should rather acknowledge the importance or at least the relevance of some non-welfarist arguments, as I will argue below.

A possible strategy to define paternalism is the following. Paternalism is considered as a residual category, meaning that if we cannot find a (possibly implicit) reason for intervention in terms of a market failure or other third party effect, we attribute the regulation to paternalistic purposes. But, of course, we cannot strictly follow this conceptual strategy even if it seems preferable in order to avoid coming forward with a direct definition. This is so because there are possibly other reasons not

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<sup>4</sup> For the philosophical literature on paternalism, see e.g. Sartorius 1983, Kleinig 1984, Feinberg 1986, Suber 1999, Dworkin 2002.

<sup>5</sup> Eidenmüller 1995, 360.

<sup>6</sup> See Rawls 1993.

falling into the category of market failure which are nevertheless not paternalistic. Moralism, reasons relating to commonly shared values, etc. come into mind. Also, in the contractual context it is rather unlikely that externalities are a serious concern, especially in cases where this reason would concur with paternalism. So we could call the definition rather eliminative, thus we use both a positive characterization and we make clear what the fundamental differences of paternalism and other reasons are.

In defining and evaluating paternalism, we shouldn't confound words. There might be other values competing with freedom (autonomy) and not everything valuable is a sort of freedom. So if we want to limit freedom of choice in certain situations, then it is better to say that in a given case there are good reasons for preferring something else, e.g. well-being or security to freedom, instead of arguing that it is 'real' or 'positive' etc. freedom that is promoted by paternalism.<sup>7</sup> At least if we define paternalism in the way that it implies doing something against the (free) will of the agent.

A conceptual problem with paternalism is that what free will (voluntary consent) in a specific context means is not easy to tell, as there is no self-evident reference point or threshold. Or more precisely, there are a number of criteria that should be fulfilled for an action to count as fully autonomous. In practice this is an unattainable ideal thus the autonomy is always limited. This however does not in itself justify paternalistic intervention.

There are three conditions that are usually included in the definition of paternalism. Thus the paternalist (1) intentionally limits the subject's liberty, (2) acts primarily out of benevolence toward the subject, (3) and disregards (is not motivated by) the subject's contemporaneous preferences.

## **2.2. Hard and soft paternalism**

There is a useful distinction in the literature between hard (strong) and soft (weak) paternalism. Both forms are restricting individual liberty but while soft paternalism applies to actions which are not fully voluntary or informed and thus the intervention is not especially controversial (more easily justified), in case of hard paternalism this justification is more problematic.

The standard distinguishing feature of hard paternalism is that the subject's conduct is substantially voluntary. Thus the lack of substantial voluntariness negates the value of autonomy with regard to that conduct. There are three subconditions of this substantial voluntariness:

1. Capability of making choices (even if the decisions are foolish, unwise, reckless, these are still decisions of an autarchic subject)
2. Substantial freedom from controlling influences such as coercion, duress, or manipulation
3. Substantial freedom from epistemic defects, such as ignorance of the nature of her conduct or its foreseeable consequences.<sup>8</sup>

So if the subject's conduct is substantially voluntary, then liberty limitation with respect to such conduct is hard paternalism and conversely, if the subject's conduct is not substantially voluntary for any of the three reasons above, then liberty limitation

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<sup>7</sup> This is the view expressed in Burrows 1993, one of the few L&E articles in favour of paternalism.

<sup>8</sup> See Pope 2004, 711-713, and references there.

with respect to such conduct is soft paternalism.<sup>9</sup>

The importance of the distinction becomes clear if we note that soft (weak) paternalism is arguably not paternalism in any interesting sense, because it is not based on a liberty-limiting principle independent of the harm principle. In this case, the intervention is defended as a protection from harm caused to the individual by conditions beyond his control. Thus contract law rules of fraud, duress and mistake can be conceptually distinguished from paternalism.<sup>10</sup>

Of course, when we come about with suggestions for intervention etc. we rely on a standard of rationality, according to which weakness of will, sour grape mechanism etc. are irrational behavioural patterns. This strategy implies, however that we are not speaking about real world individuals any more, but about abstract subjects of a certain quality: autonomy. And this autonomous self can be in conflict with the other features of the very same person. And it is not evident, what features belong to this abstract person and what is an anomaly. This is an everyday methodological problem in economics. E.g. it is not clear if extreme risk aversion is to be corrected for or an individual's risk attitude is just a datum which cannot be the object of regulation, manipulation etc. as belonging to the person making the decision.

### 2.3. Problems of justification

In the philosophical literature there is no consensus on the justifiability of paternalism. As far as normative philosophy is concerned, however, I try to avoid taking side in far-reaching metaphysical debates in this work. Basically I will follow the late John Rawls' ideas about 'public reason' and 'overlapping consensus'<sup>11</sup> and thus use arguments that can be, on a middle level of abstraction, acceptable or at least reasonable from several comprehensive philosophical/ethical perspectives. Although I don't think that this is the only reasonable way to do political/legal philosophy, by 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 a general acceptance of the minimization of social costs as the objective of tort (accident) law.<sup>12</sup>

Paternalism does not refer to a distinct class of actions but to a class of reasons that we may use to justify or condemn restrictions of liberty. Liberty-limiting principles include (1) harm principle, (2) offence principle, (3) moralism, (4) paternalism. Since the ideas of J. S. Mill about the limits of state power and the harm principle as the only acceptable justification for the use of coercion against competent individuals has become widespread, paternalism has been a central problem of legal and political theory. Paternalism is problematic from the liberal point of view as it implies promoting

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<sup>9</sup> In the philosophical literature, T. M. Pope criticizes this distinction of hard and soft paternalism as it is not defined by the reason of the agent for limiting the subject's liberty (Pope 2004). According to Pope, if the agent disregards (doesn't care) whether the subject's conduct is substantially voluntary or not and limits his liberty notwithstanding, he exercises hard paternalism. It is, however, not clear, why should we care about this difference between the 'objective' voluntariness' of the subject's conduct and the paternalist's perception if it at the level of definition, and not at the level of justification instead.

<sup>10</sup> This is the way Feinberg defines his version of paternalism, by saying "soft paternalism would permit us to protect him from 'nonvoluntary choices,' which, being the genuine choices of no one at all, are no less foreign to him." (Feinberg 1986, 12)

<sup>11</sup> See Rawls 1993.

<sup>12</sup> R. Posner 1995, 505.

the good of a person against his (free) will thus violating individual autonomy for the sake of the individual's welfare. The freedom-diminishing character of paternalism raises a moral question about it. As for justification, paternalism is not such an essentially condemnable thing as murder: it is rather like killing which has justified and unjustified cases. The moral interest of paternalism comes from the juxtaposition of two values: freedom and benevolence.<sup>13</sup>

Historically, the problem of justifying paternalism is linked to the rise of liberalism and the value of individuality. Speaking about earlier ages and different cultures, we are inclined to use another term, patriarchalism. Patriarchalism is a social order in which the patriarch's concern to secure individual good is subsumed under a general good that gives it definition and to which it contributes. E.g. in the medieval European social and cultural setting, characterized by general views on the *relational nature* of the self who is embedded in his roles, patriarchalism was backed by generally accepted values. By contrast, in case of paternalism we conceive the good of the paternalised individual as sufficiently independent of the good of others or some social whole to constitute *on its own* a focus of attention.

Nevertheless, H. Eidenmüller, in a German legal context considers paternalism justified only (or usually at least) if it promotes autonomy and he states that we have to recur to general constitutional principles and objective values.<sup>14</sup> He also mentions that justification in a non-legalistic sense, i.e. beyond the reference to the constitution can be based mainly on some sort of hypothetical consent. And then weakness-of-will, and the institutions that are collectively imposed against them, may be problems of self-paternalism. The autonomous, rational side defends itself from the irrational other, like in the paradigmatic case of Ulysses and the sirens.<sup>15</sup> This line of reasoning (justifying paternalism by hypothetical consent) is, however, missing the point of the problem because this hypothetical consent behind the rule runs, in case of hard paternalism, against the actual will of the subject. Also, it is rather improbable that there are a large number of paternalistic rules that can be backed by such hypothetical consent.

There is a related argument against all sort of paternalism which is independent of the Mill-Feinberg line of reasoning based on autonomy. It is stressed by Sugden, following Hayek and raises doubts about the superior knowledge of the "pater". That is, even if the dictator is benevolent, he is possibly ignorant. This argument is quite strong and it has bite for a much wider class of reasons than paternalism. In its extreme form, it works against all non-spontaneous, deliberate, planned law and rule governing the behaviour of others; though in this unqualified form its relevance is rather limited.

Legal paternalism has to deal with a specific problem worth mentioning. Additional to the justification of the limitation of freedom in individual cases, the *legal* nature of paternalism, i.e. that it is formulated in universal, general rules is problematic as well. Thus even if it might be justified to interfere in individual cases, the general rule would diminish the freedom of those who do not need to be assisted. This problem of the over-inclusiveness of rules vis-à-vis their background justification is the consequence of the generality of rules.<sup>16</sup> It is not unknown in the law and economics literature either. It is a special case of how to find the optimal mix of rules and standards (or the division of labour between legislation and the judiciary) in regulation. In another

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<sup>13</sup> Kleinig 1984, ch. 1.

<sup>14</sup> Eidenmüller 1995.

<sup>15</sup> Cf. Elster 1984, 2000.

<sup>16</sup> The classic literature on the topic is, of course, Schauer 1991. See also Schauer 2003.

sense, it points to the redistributive consequences of paternalism.<sup>17</sup> Namely, the costs of paternalistic rules are born by the rational individuals who don't need the assistance of the law but are actually impeded by it to carry out their actions as they want.

In law we can see an uneasy relationship of general principles and specific rules in another way as well. Namely, if we want to analyse a given legal doctrine non-dogmatically, i.e. not by asking for its technicalities, wording, or its place in a larger body of the legal system etc. but critically, looking for reasons justifying it, we often find that a given rule can be backed by several, often contradictory principles. Due to this *over-determination* we might not see clearly if a given rule is the expression of paternalism, self-interest of an influential group, symbolic expression of a generally held value (moralism) or the instrumentally rational response to an externality problem. To be more concrete and come closer to our topic, Michael Trebilcock brilliantly shows in his book on the limits of freedom of contract<sup>18</sup> how a given legal rule erecting such a limit can be backed by arguments coming from different legal and political philosophies. At this point, to be sure, we are back to the argument about the overlapping consensus. When analysing legal rules of contract, often we can show that the freedom of contract or an intervention limiting it can have several justifications which are not necessarily coherent with each other. On the other hand, I will try to find and use arguments which are capable of creating this overlapping consensus in a limited area of law: the law of contracts.

## 2.4. Freedom of contract

Freedom of contract is an ideologically charged notion which may attract strongly-held political beliefs but which eludes the interest of the lawyer in his everyday work for the most part. Nevertheless, the question of freedom of choice and its limits have crucial importance in law, especially contract law. For instance, the validity of a contract, liability and remedies are often conditional on the (in)voluntariness of one party's action. There are also several typical cases when modern legal regimes set limits on the general principle of freedom of contract, for good or wrong reasons (labour law, consumer protection etc.). Paternalism is arguably one of these reasons.

Let's see briefly how freedom of contract is treated in moral and legal philosophy. Behind the law of contracts, a central subject area of private law lays a broad set of economic, social and political values that define the role of markets in modern developed countries. But markets are not the sole mode of social organisation. As Heilbroner argues, societies may organise production and distribution basically through three institutions: tradition (social conventions and status), command (centralised information gathering and processing and coercion) and market (decentralised decisions). Most of the societies usually combine all these three organisational modes. At the same time a modern developed society, mainly based on market-type production and distribution has to cope with certain backdrops of the market economy relative to the two other modes of social organisation (such as the potential for dramatic shifts in consumption and production, the destabilisation of personal, social and communal relationships, and a significant degree of inequality). Despite a relatively wide consensus in favour of economic liberalism and the market economy, there remain many troubling and potentially divisive normative issues about

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<sup>17</sup> See Mitchell 2005.

<sup>18</sup> Trebilcock 1993.

the extent of markets and freedom of contract.

Michael Trebilcock calls this consensus, together with its theoretical underpinnings the *private ordering paradigm*. In neo-classical economics this "predilection for private ordering over collective decision-making is based on a simple (perhaps simple-minded) premise: if two parties are to be observed entering into a voluntary private exchange, the presumption must be that both feel the exchange is likely to make them better off, otherwise they would not have entered into it."<sup>19</sup> To rebut this presumption we have to refer either to contracting failures or market failures. These constitute (from an economic perspective) the reasons for the limits of freedom of contract. Or, as Milton Friedman has put it: "The possibility of coordination through voluntary cooperation rests on the elementary – yet frequently denied – proposition that both parties to an economic transaction benefit from it, provided the transaction is bilaterally voluntary and informed."<sup>20</sup>

What is then the role of contract law from an economic perspective?<sup>21</sup> In general, it facilitates the voluntary (and well-informed) exchange of well-defined and exclusive private property rights. First, it is a "check on opportunism in non-simultaneous exchanges by ensuring that the first mover, in terms of performance, does not run the risk of defection, rather than co-operation, by the second mover."<sup>22</sup> Second, it reduces transaction costs. Third, it provides a set of default or background rules where the terms of a contract are incomplete. Forth, it distinguishes welfare-enhancing and welfare-reducing exchanges.

Utilitarianism, arguably (in one form or another) the principal background philosophy of contemporary economics is used to be criticised on the basis that it accepts existing preferences as given, it does not offer "ethical criteria for disqualifying morally offensive, self-destructive, or irrational preferences as unworthy of recognition." If, on the contrary, economic theory acknowledges some exceptions, as it has to, at least in case of minors or mental incompetents, then "some theory of paternalism is required, the contours of which are not readily suggested by the private ordering paradigm itself."<sup>23</sup> All the economically-minded literature on paternalism<sup>24</sup> try to justify paternalism by considering special preference structures (path-dependent preferences) or informational asymmetries in game-theoretical settings (perfectly informed principal vs. uninformed agent).

There are as we have seen non-economic justifications for the primacy of private ordering (and the rejection of paternalism) as well, which are based on individual autonomy (negative liberty) as a paramount social value. These liberal theories see the law of contracts as a guarantee of individual autonomy. On the other hand, there are some other stances of political philosophy which are more ambivalent toward freedom of contract, such as theories based on the positive (affirmative) concept of liberty which are concerned with the fairness of distribution of welfare (equality) in society; and communitarianism that emphasises the essentially social nature of man (fraternity).

These four theories about freedom of contract partly cohere and converge but

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<sup>19</sup> Trebilcock 1993, 7.

<sup>20</sup> Friedman 1962, 13.

<sup>21</sup> See Shavell 2003.

<sup>22</sup> Treilcock 1993, 16.

<sup>23</sup> Treilcock 1993, 21.

<sup>24</sup> E.g. Burrows 1993, 1995, Zamir 1998. On paternalism in contract law, see also Kennedy 1982, Kronman 1982, Spengel 1988.

partly contradict each other. To be able to construct a normative theory of the law of contract and deduce arguments from it for or against certain limits of freedom of contract, the complex relationship "between autonomy values and welfare (end-state) values (efficiency, utility, equality, community)" shall be cleared.<sup>25</sup> If we explore the congruencies and conflicts between current moral and political philosophies and their normative implications regarding the fine details of the law of contracts and contrast them with our moral intuition and legal rules in force, we will probably come to the conclusion that neither autonomy-based theories nor different sorts of utilitarianism nor communitarianism can offer alone a coherent theory about freedom of contract. For our present purposes, it is more important to see that the "convergence claim" (i.e. that a market ordering and freedom of contract simultaneously promote individual autonomy and social welfare) may be true in certain contexts but it is not robust enough to be true in general. An additional lesson is that there are problems (market failures) which cannot be appropriately addressed judicially, i.e. in a contract law setting where private law constrains the freedom of contract. This can be thus an argument for a mix of policy instruments.<sup>26</sup> In general, the plurality of the theories represents confronting purposes which, in turn can be achieved only by a plurality of institutions.

## **2.5. Non-paternalist limits on freedom of contract**

As mentioned before, there are a few concurrent justifications beside paternalism for limiting freedom of contract which are not always easily distinguishable from each other and from paternalism.

### **2.5.1. Externality and harm**

Externalities mean imposition of costs or benefits from a particular exchange transaction on non-consenting third parties. Positive externalities pose incentive problems (lead to suboptimal quantity of the good in question). Negative externalities are arguably more important and serious. Autonomy-based theories formulate the same negative effect under the name 'harm' (or, within another category of Joel Feinberg's scheme: 'offence'). The crucial conceptual problem here is that third-party effects (externalities in economics, harm in liberal theories) are pervasive. If all these effects should count in prohibiting the exchange process or in justifying constraints upon it, freedom of contract would be largely at an end. Once one moves beyond rather tangible harms to third parties, many activities might be viewed as generating some externality (imposes costs on dependants, the social welfare system or the public health care system), including inadequate dietary or exercise regimens, excessively stressful work habits, risky leisure activities. As we have seen, economists are still willing to refer to externalities in order to justify laws which on their face are paternalistic (e.g. safety measures).

### **2.5.2. Coercion**

The seemingly simple question of what constitutes voluntary consent to a transaction is actually a serious conceptual problem. Suppose that there is full information, no cognitive deficiencies and the contract is complete. The question is then, whether the constrained choice of a party renders his consent involuntary. In one sense, all contracts

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<sup>25</sup> Treilcock 1993, 21. As an ambitious recent attempt to harmonise welfare-based and autonomy-based theories of contract, see Kraus 2002.

<sup>26</sup> Treilcock 1993, 248–261.

are "coerced", because of the scarcity of resources and opportunities. But on the other side, except for extreme cases (actual physical force, torture, and hypnotic trance) almost every exchange can be viewed as voluntary (*coactus tamen volui*).

Rights theorists define coercion by drawing a basic distinction between threats and offers. Threats reduce the possibilities open to the recipient of the proposal, whereas offers expand them.<sup>27</sup> The difficulties arise, however, in specifying the offeree's baseline, against which the offer is to be measured. This measure is not self-evident. It may be statistical (what he might reasonably expect), phenomenological (what he in fact expects), or moral (what he is entitled to expect). Thus "the distinction between threats and offers depends on whether it is possible to fix a conception of what is right and what is wrong, of what rights people have in contractual relations independent of whether their contracts should be enforced."<sup>28</sup>

There are other approaches to contractual coercion, elaborated e.g. from a Hegelian or an Aristotelian perspective which are based on different theories of substantive fairness, or still others that are based on hypothetical, rather than actual consent and thus invert the conventional arguments of economists for voluntary exchanges, mentioned above (while there voluntariness implies welfare-improvement, here the other way around). The implications of these theories for different cases of constrained choice diverge.<sup>29</sup> Still, as long as they justify the non-enforcement of a coerced contract, they do that for reasons which are essentially different from paternalism, as they are not constraining but respecting the free will of the person.

### **3. Analysis of paternalism with economic tools: mainstream, and others**

Freedom of contract and paternalism are perhaps too general issues to be very commonly treated in law and economics in this way, but they are especially interesting as they point to the limits of economic methods in the social scientific research of legal problems. In this sense, the subject raises a number of methodological problems for economics. More precisely, in order to analyse legal problems with a rational choice methodology, my starting point is the literature on the economic analysis of (contract)

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<sup>27</sup> See Nozick 1997.

<sup>28</sup> Trebilcock 1993, 80.

<sup>29</sup> Trebilcock construes seven cases and demonstrate the implications of the different theories. (1) The highwayman case (creation and exploitation of life-threatening risks: a highwayman or mugger holds up a passerby confronting him with the proposition: 'Your money or your life' and the passerby commits himself to hand over the money). (2) The tug and foundering ship case (exploitation but not creation of life-threatening risks: a third party encounters the highwayman and the passerby before the transaction is consummated and offers to rescue the passerby for all his money, less one dollar. Or imagine the same situation between a foundering ship on the stormy sea and a rescuing tug). (3) The dry wells case (exploitation but not creation of life-threatening risks with one supplier and many bidders: in a remote rural area all wells except from A's dry up in a drought and A auctions off drinking water to desperate inhabitants for large percentages of their wealth. Or, the same sea situation with several ships and one rescuer). (4) The Penny Black case (exploitation but not creation of non-life-threatening situations: A comes across a rare stamp in his aunt's attic and sells it either to B exploiting his idiosyncratic intense preferences or through a Sotheby's auction to the highest bidder). (5) The lecherous millionaire case (A agrees to pay for a costly medical treatment of B's child [or offers her an academic position or a promotion in the firm] in return for B's sexual favours). (6) The cartelised auto industry case (contrived monopolies: major automobile manufacturers form a cartel to curtail drastically consumers' rights of action with respect to personal injuries). (7) The single mother on welfare case (non-monopolised necessity: a person in necessity contracts with another who lacks monopoly but the terms are especially burdensome to the first, reflected in high risks and low return).

law. But as the findings of this branch of literature are rather unsatisfying when applied to the problem of paternalism, the research methods themselves come into focus – at least in this section of my analysis.

At first glance, it is relatively easy to incorporate paternalism in mainstream economic analysis: we just have to define specific preferences and/or specific informational imperfections and asymmetries. Altruism, merit goods have been treated in economics since several decades.<sup>30</sup> Alternatively, we can rely on the emerging literature of behavioural law and economics.

On a more general level, I think that the tools recently developed within two branches of economics can contribute to a new perspective on the question of freedom of contract and paternalism which is more coherent and fruitful than we currently have. As for the substantive questions at issue, by confronting economic arguments with philosophical and jurisprudential considerations, I suggest modifying the traditional law and economics arguments about paternalism in two ways: (1) the empirical findings of behavioural economics offer a more realistic view of the situations susceptible for paternalistic intervention, (2) the analytical tools of the freedom of choice literature help to clarify the non-welfarist dimension of the problem. These two schools are different concerning their theoretical background but their implications for contract law might complement each other.

On a more concrete level, as Russell Korobkin argues in a recent paper,<sup>31</sup> if our purpose is to come up with legal policy recommendations, we have to decide pragmatically, in any concrete case, whether the rational-choice or the behavioural theory offers a more plausible explanation of the phenomena analysed. Nevertheless, it is primarily the service of psychologists and behavioural scientists to have pointed out the possible target situations of paternalism.

### 3.1. Behavioural economics

In light of this, in analysing paternalism in contract law I draw on findings of behavioural law and economics about how people behave in front of legal rules in experimental or real world settings. Here, the assumptions concerning the rationality of individual choice have an important but limited role. Without going into details now, I only mention that to use the assumptions of instrumental rationality and utility maximization in modelling in an explanatory science only makes sense as long as the hypothesis that people in real world settings do indeed behave according to these rules, has some plausibility. In other terms, as some people argue, rational choice theory is a *normative* theory about how a rational individual *should* decide and choose. The use of these models in an *explanatory* context is thus “parasitic”<sup>32</sup>, i.e. secondary to its role as a normative standard and conditional on it.

If we want to understand and explain how real-world people behave in front of law we have to draw on non-standard economic models of individual decision-making at least *in some contexts*, including bounded and biased instrumental rationality or expressive rationality. One short remark on bounded rationality is in place. Here not the more specific ideas of Herbert Simon about satisfying behaviour etc. are meant (there are good arguments that this is one very specific model and there is no empirical support that it would be correct context-independently or at least in a wide range of real

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<sup>30</sup> See, e.g. Collard 1978, Head 1966.

<sup>31</sup> Korobkin 2004.

<sup>32</sup> See Sen 2002, ch. 1.

world issues) but the more general (and thus less precise) idea that human behaviour systematically deviates from the standard models of rational choice. Thus behavioural law and economics does not rest on a theory or definition of bounded rationality that would allow the decisions of the contracting parties to be axiomatised. Rationality as such has a strong place in social science. But here, rationality is defined at most negatively, as an absence of Savage-type rationality. In this matter the theory remains inductive: there are specific behavioural regularities which are highly relevant for us, even if we cannot fully explain them.

First I focus on the question, why and how behavioural economics can be interesting for the economic analysis of contract law. The empirical findings of behavioural economics on the cognitive characteristics of contracting parties are abundant and relatively widely known. The well-documented and systematic cognitive deficiencies of individuals may justify some paternalism in certain contractual contexts. Thus a careful choice of potentially sticky default rules, mandatory warnings or cooling-off periods are some forms that seem justified in light of these results. In general, behavioural law and economics argues for a change from anti-paternalism to anti-anti-paternalism, i.e. a critical, qualified and limited paternalism which takes into consideration that not only (at least one of) the contracting individuals but also the legislator/regulator is imperfectly rational or not fully informed e.g. about certain risks.<sup>33</sup>

Several proponents of behavioural law and economics refer to the well-documented deficiencies of human rationality<sup>34</sup> which *per se*, in their view, justify paternalism or at least anti-anti-paternalism. But this literature is often not explicit about the normative issues involved in the problem of paternalism or tries to reduce them to a welfarist calculus of costs and benefits. As noted above, in the literature informed by rational choice theory, there is a conceptualisation of paternalism (different from the usual philosophical approach) which treats the question of paternalism as a multiple self problem or even an ‘intrapersonal externality problem’. In certain cases of soft paternalism (i.e. when the paternalised subject is *not* a fully competent and fully informed individual), it is possible to argue that by imposing on him we defend his true self against weakness of will or mistake etc. E.g. those who argue for ‘asymmetric’ paternalism on a behavioural economic basis,<sup>35</sup> tend to compare the real world agents with the fully rational individual (assumed in orthodox economic models) and to say that bounded rationality is something which can be justifiably regulated in a similar way as externalities. Here, of course, we have, first, to suppose the existence of a true ‘inner self’ characterized by desires and beliefs which are undisputed, accepted as rational (or at least not irrational in a way that requires intervention) and, second, to explain the behaviour of real world individuals as cases when this inner self falls prey to certain anomalies.

As already mentioned, it is not always easy to tell what is given and part of the autonomous self and what is subject to potential paternalistic correction. Attitudes toward risk, for instance, are usually taken as datum. But in the experimental results we see that these attitudes are context-dependent, differ for gains and losses, and depend also on the amount of value at stake – the cognitive background of risk perception is thus too complex to allow for an easy conclusion.

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<sup>33</sup> Jolls et al., 2000. A useful German summary of the literature is Englerth 2004.

<sup>34</sup> I refer here to the literature on hindsight bias, availability heuristics, framing effect, prospect theory etc.

<sup>35</sup> Camerer et al. 2003. See also Rachlinsky 2003, Sunstein – Thaler 2003a, b, Mitchell 2005.

There is a further problem with this sort of definition of paternalism. If consumers had the choice between possible default rules, mandatory warnings, cooling-off periods (these are some typical forms of rules suggested by the adherents of ‘asymmetric paternalism’) in an individual manner, maybe they would want some protective rules for themselves. Then the regulation cannot, without qualification, be called paternalistic. It is rather the expression of a hypothetical consent or the collective self-protection of the boundedly rational individuals against their own weakness of will, etc. This reformulation of the paternalistic rules as the result of *collective self-protection* could illustrate the more general point that not every legal regulation intending to promote or defend consumers’ interest can be called paternalistic just because of this purpose.

The behavioural literature often reflects a strong and devoted antipathy towards philosophical discussion of the problems of paternalism. They claim to be the representatives of ‘pure science’, offering hard empirical facts and being able to cut through dusty disputes about “faith” by pointing at empirical facts.<sup>36</sup> I think this attitude is rather unfortunate. Empirical research is crucial in answering questions about the best possible way to design legal rules of paternalism and even in the discussion of the reasons for paternalism.<sup>37</sup> But this literature also uses a normative benchmark, namely that of welfare, measured in an acknowledgedly simplistic way by cost and benefits.<sup>38</sup>

More precisely, it is argued that ‘asymmetric paternalism’ is justified (in a firm/consumers setting) if

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

where  $B$  denotes the net benefits to boundedly rational agents,  $C$  is the net costs to rational agents,  $I$  stands for the implementation costs,  $\Delta[\pi]$  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). Thus “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.”

Even if we put aside the question how to measure and quantify these variables, this kind of literature does not fully reduce the problem to an issue of facts. There remains the question whether and how the method of only using arguments about costs and benefits can be justified, for it is far from self-evident.

### 3.2. Freedom of choice: the non-welfarist dimension of paternalism

As noted above, the traditional economic approach of freedom of contract is an unreflected mixture of liberalism and utilitarianism and as such it cannot handle the problem where these two principles are in conflict. Thus the potential conflict of wealth-maximisation and autonomy draws attention to the non-welfarist dimension of the problem of paternalism.

The philosophical literature on autonomy, liberty, and paternalism often lack the conceptual rigour or the degree of formalisation which would make the arguments directly accessible for the economic analysis. And conversely, economists cannot include relevant and important philosophical ideas in their analysis as long as they

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<sup>36</sup> Camerer et alii 2003, 1222.

<sup>37</sup> On the empirical research in contract law scholarship see Korobkin 2002.

<sup>38</sup> Camerer et alii 2003, 1219.

cannot translate them to their language. Hence the relevance of the economic analysis of freedom of choice and the use of social choice theory to formalise, measure and evaluate freedom of choice.<sup>39</sup> Authors of the freedom of choice literature, besides searching for a formal method to measure freedom of choice, usually argue for the importance of non-welfarist measures of well-being, including freedom. This literature treats paternalism, if at all, as a restriction of autonomy and freedom and evaluates it in a clearly negative way. Still, it makes possible to analyse the issues about freedom in a conceptually clear and rigorous way.

In sum, if we want to analyse the problem of paternalism in contract law economically while not neglecting the questions of autonomy involved, we should adapt the methodology of standard law and economics scholarship to the object under study. Still, how to do that more precisely cannot be decided *in abstracto*. It is to be found out during the very process of the analysis of specific contractual rules which is still ahead.

#### **4. Contract law – freedom of contract and (paternalistic) legal policy**

By legal policy I mean a more or less coherent system of proposals for reforming legal rules. The basic idea of these proposals is that law should fulfil certain hypothetically or tacitly accepted normative criteria. In the law and economics literature, of course (Pareto or Kaldor-Hicks) efficiency is the most important among them. This policy perspective is concerned with some concrete rules in contract law from a practical evaluative point of view. More specifically, I will deal with questions about the optimal amount of paternalistic regulation in contract law and then make proposals how to improve them. This level of analysis is, to be noted, based on the justification of paternalism (“what are the reasons for leaving people freedom of choice or to intervene paternalistically?”) and some empirical facts or hypotheses (“what are the effects of freedom of choice in contract law, what is to be expected as the result of legislative intervention?”) and combines them in order to contribute to the legal policy discourse about the best legal means to achieve some (at this level) given goals.

The economic analysis of contracts and the economic analysis of contract law are two different issues. The second is much more specific, relates mainly to the institutional framework in which transactions, governed by contracts, take place. But these two are not only in a whole and part relation because, normatively, one objective of legal scholarship is to design contract law in such a way as to influence the contracting parties in a certain direction or at least to offer a framework within which they operate.

There are some specificities of contract law with respect to paternalism. It is the area where, as a general rule, a private ordering applies to the individuals, namely the provisions of their contract. Thus the state only enforces the promises the parties make to each other and the general claim that law as such is interfering with individual autonomy and thus essentially problematic possibly does not apply to contract law. Another specificity is that paternalism in contract law can be observed in two different forms. First, it may be regulation by legislative or administrative rules, formulated in general terms and applicable for every individual case uniformly. These rules lie, structurally or doctrinally, often outside of traditional contract law (e.g. in labour law, administrative law. etc.) even if they restrict the power of individuals to bind

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<sup>39</sup> Cf. Van Hees, 2004, Sugden 1998.

enforceable contracts. On the other hand, there are several contract law doctrines which can be interpreted as motivated by paternalism. These are usually formulated as vague standards, leaving a relatively wide scope of discretion to the judiciary. Thus, e.g. it is for the judge to determine in individual cases whether a certain provision of a contract is “unconscionable.” Thus we face a trade-off here. If the question of the legality (enforceability) of a contract term is left to ex post case-by-case determination, then the over- and underinclusiveness of a general rule is avoided at the price of more ex post regulation by judges.

Contract law deals with several typical situations where at least one contractual party has imperfect information. Both asymmetric and symmetric information imperfections are possible cases for paternalistic intervention.

In general, the problem of asymmetric information is not easily distinguished from paternalism. The question here is: how much information is required for the exercise of an autonomous choice. Or stated differently, if one party to a contract is substantially less well informed about some aspect of the subject matter than the other, should contracts be unenforced or enforced on different terms, on that account. The problem is, of course, that information is almost always imperfect.

In terms of the doctrines of common law these information failure cases include fraud, negligent misrepresentation, innocent misrepresentation and material non-disclosure. In behavioural terms, information processing disabilities or cognitive deficiencies (“transactional incapacity” and “unfair persuasion”) also belong here, along with the issue of standard form contracts.

Symmetric information imperfections correspond to the domain of contract doctrines relating to frustration, contract modification and mutual mistake. These legal doctrines define the scope of permissible private or judicial adjustments to contractual relationships in the light of new information. Law and economics literature generally argues that in long-term relationships there is a range of contractual and other strategies for adjusting the allocation of unknown and remote risks: explicit insurance, hedging in futures markets, indexing clauses, ‘gross inequities’ clauses, arbitration clause, etc. The absence of these from a long term contract thus reasonably implies that the promisor agreed to assume the risk in question. Still, there might be cases when this sort of informational deficiency justifies mandatory legal rules.

There are thus several contractual doctrines (mandatory disclosure, cooling-off periods, unconscionability) that are intuitively classified as paternalistic. Still, in an economic sense they operate rather differently. Suppose two parties conclude a contract about the transfer of an asset with uncertain value (low or high, with some probabilities). Consumer sovereignty (“consumers should get what they want”), as cited above from Trebilcock and Friedman, whether it is ultimately justified with welfare arguments or autonomy arguments or otherwise, sets a presumption against judicial intervention in this transaction.

Disclosure rules are about communicating information that there is a risk. It may be written in fine print and thus there are arguments for requiring bigger letters. This can be justified in pure economic terms: it is less costly for the seller to produce the information. But the whole issue is clearly dealt with in the time before the realization of the risk.

The rule providing a mandatory cooling-off period is arguably to cure the problems of weakness of will, e.g. in door selling situations, by aggressive sales techniques etc. It is not obviously paternalistic. In theory, the sellers are interested to tie

themselves and offer this option by themselves to the buyers. The cooling-off period is usually short, ending (for good economic reasons) before the realization of the risk, often even before the delivery of the good. (Still, in the EU the regulation is different; the good is already delivered during the 14 days period.)

The third doctrine, unconscionability works differently. Technically, it works as an excuse when the seller wants to recollect money and the buyer, after finding out that he had bad luck (the low-value case realized), ask the court for assistance to rescind from the contract.<sup>40</sup> If unconscionability is applied for cases of the transfer of a good of uncertain value, this is in some sense opportunistic: only those with bad luck go to the court or have to go there because of non-payment. But, of course, the doctrine is not only or primarily applied to the case of risky exchanges. There may be a fully riskless, but simply involuntary exchange at issue, where judicial remedy is at place, even if we face coercion or fraud and not (hard) paternalism in the meaningful sense of the word. Still, as the state of mind of the contracting parties is in most cases practically improvable, unconscionability is used as a proxy. Apart from this, there is some space for paternalistic intervention, in the case of systematic cognitive failures.

In dealing with questions about the optimal amount of paternalistic regulation in contract law and then making proposals how to improve them necessitates more specific scrutiny on specific contract law rules. In my further work I will concentrate on a small number of contract law rules which are planned to be part of the new Civil Code of Hungary and contrast them with the previous rules and current European contract law regulations. The draft of the new Hungarian Civil Code is the work of legal scholars slightly influenced by *law and economics* and strongly relying on European codifications and model rules. The contract law rules of the new Code are especially interesting as they are fashioned acknowledgedly primarily for business to business transactions thus are supposed to be adapted to commercial settings and repeat players. Private one-shot contracts among inexperienced players are handled as exceptions. Apart from these two groups of contracts, as the implementation of some EU directives a relatively large body of special regulations will deal with the consumer contracts. This rather formal typology suggests that there are at least three different contexts where the role of paternalism should differ.

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<sup>40</sup> An early law and economics analysis of unconscionability is Epstein 1975. For a comparison of mainstream and behavioural economic arguments on unconscionability, see Korobkin 2003a,b.

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