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Foreward: The Rise of Behavioral Law and Economics

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Recommended Citation

Stucke, Maurice, "Foreward: The Rise of Behavioral Law and Economics" (2012). *UTK Law Faculty Publications*. 764.

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DATE DOWNLOADED: Wed Apr 13 14:15:55 2022

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Citations:

Bluebook 21st ed.

Maurice E. Stucke, The Rise of Behavioral Law and Economics, 13 Transactions: TENN. J. Bus. L. 309 (2012).

ALWD 7th ed.

Maurice E. Stucke, The Rise of Behavioral Law and Economics, 13 Transactions: Tenn. J. Bus. L. 309 (2012).

APA 7th ed.

Stucke, M. E. (2012). The rise of behavioral law and economics. Transactions: The Tennessee Journal of Business Law, 13(2), 309-314.

Chicago 17th ed.

Maurice E. Stucke, "The Rise of Behavioral Law and Economics," Transactions: The Tennessee Journal of Business Law 13, no. 2 (Spring 2012): 309-314

McGill Guide 9th ed.

Maurice E. Stucke, "The Rise of Behavioral Law and Economics" (2012) 13:2 Transactions: Tenn J Bus L 309.

AGLC 4th ed.

Maurice E. Stucke, 'The Rise of Behavioral Law and Economics' (2012) 13(2) Transactions: The Tennessee Journal of Business Law 309

MLA 9th ed.

Stucke, Maurice E. "The Rise of Behavioral Law and Economics." Transactions: The Tennessee Journal of Business Law, vol. 13, no. 2, Spring 2012, pp. 309-314. HeinOnline.

OSCOLA 4th ed.

Maurice E. Stucke, 'The Rise of Behavioral Law and Economics' (2012) 13 Transactions: Tenn J Bus L 309

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VIRTUAL SYMPOSIUM

FOREWORD: THE RISE OF BEHAVIORAL LAW AND ECONOMICS

MAURICE E. STUCKE*

Many of you likely encountered law and economics in law school—perhaps in a law and economics seminar or in a particular class, such as discussing efficient breach in your contracts course. Some of you, however, had difficulty identifying with *Homo Economicus*—namely, the rational, self-interested profit-maximizer who acts with great willpower.

The economics literature over the past thirty years has moved beyond neoclassical economic theory's assumptions of perfectly rational market participants who pursue, with willpower, their economic self-interest. These assumptions came under attack from several interdisciplinary economic fields, most notably behavioral economics. Behavioral economics attempts to integrate psychologists' understanding of human behavior into economic analysis. Over the past thirty years, the economic literature increasingly recognized and measured when and how (i) willpower is imperfect, (ii) people will incur costs to punish unfair behavior and care about the fair treatment of others, and (iii) biases and heuristics affect decision-making.

Behavioral economics, the management consulting firm McKinsey & Company recently observed, "is now mainstream."¹ Best-selling books feature behavioral

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¹ Dan Lovallo & Olivier Sibony, *The Case for Behavioral Strategy*, MCKINSEY Q., Spring 2010, at 30.

economics,² which is now a staple in graduate economics programs, business schools, and, increasingly, law schools.

Behavioral economics, while popular before the economic crisis, is especially relevant today. The economic crisis raised important issues of market failure, weak regulation, moral hazard, and our lack of understanding about how many markets actually operate. In 2011, the Organisation for Economic Co-operation and Development (OECD) noted how “the worst financial and economic crisis in our lifetime”³ has prompted policymakers to ask: “Are our economic theories, our economic models, and our assumptions still appropriate?”⁴ The Obama administration is considering the implications of behavioral economics in the areas of health, finance, media, and law. The United Kingdom, among other countries, is also turning to behavioral economics.⁵

Students at the University of Tennessee College of Law are also considering the policy implications of behavioral economics, once one relaxes the assumptions of rationality, willpower, and self-interest. How can the government incorporate behavioral economics to model the impact of policy interventions? What is the role of government if individuals make mistakes or have self-control problems that make them act against their own well-being? What are the policy implications of behavioral economics in the courtroom? What are the policy implications if firms suffer biases and heuristics or if the government is relatively more or less rational than market participants? What does behavioral economics add to (or take away from) the policymaker’s toolkit?

Students in the behavioral law and economics seminar consider two overarching concerns. The first is creeping authoritarianism. To protect its citizens, the government places greater restrictions on the citizens’ ability to manage their affairs.

² See, e.g., DAN ARIELY, *PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS* (2008); DANIEL KAHNEMAN, *THINKING, FAST AND SLOW* (2011); RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* (2008).

³ ORG. FOR ECON. CO-OPERATION AND DEV., *SECRETARY-GENERAL’S STRATEGIC ORIENTATIONS FOR 2011 AND BEYOND, MEETING OF THE OECD COUNCIL AT MINISTERIAL LEVEL 2* (May 2011), available at <http://www.oecd.org/dataoecd/36/43/48064885.pdf>.

⁴ *Id.*

⁵ *Nudge Nudge, Think Think, The Use of Behavioural Economics in Public Policy Shows Promise*, THE ECONOMIST, Mar. 24, 2012, available at <http://www.economist.com/node/21551032>.

A bureaucracy that exists to protect its bounded rational citizens does not have much incentive to improve the citizens' bounded rationality and willpower. The bureaucrats' livelihood, authority, and status depend on citizens remaining sufficiently irrational to justify the bureaucracy's existence. Consumers are encouraged to register their complaints with the government, which intercedes on their behalf. The consumer complaints justify additional regulations to deter behavioral exploitation. Inevitably, the heavily regulated firms become de facto state enterprises. Under this worst-case scenario, economic competition and liberty cease to be concerns.

The second concern develops if the government takes a laissez-faire approach. Here the government renounces any intention to regulate the market, and a similar anti-democratic outcome arises. Economically powerful firms lobby the government to refrain from regulating the marketplace. While economically exploiting bounded rational consumers, firms advocate the virtues of consumer sovereignty under a laissez-faire approach. Under this ideology, markets are presumably efficient (or heading toward greater efficiency). The government fails to address market failures (or when it does act, it uses ineffective means to address the problem).

Thus our behavioral law and economics seminar navigates the risks of behavioral exploitation, ineffective governmental policies, and the risks of sacrificing economic freedom to an increasingly authoritarian government. Not surprisingly, our discussions resulted in several interesting paper topics. In addition to Grant Marshall's and Tyler Morgan's articles, the behavioral law and economics seminar produced other interesting research:

- Olatayo Atanda looked at antitrust's predatory pricing standard through a behavioral economics lens;
- Caleb Barron examined how policymakers can use behavioral economics to reduce income inequality in the United States;
- Nathaniel Dallas looked at how behavioral economics can better explain why people choose to participate in crowdfunding;
- Matthew Delinko examined what the recent Family Smoking Prevention and Tobacco Control Act does (and does not do) to combat smokers' optimism bias while Thomas Gossett explored how raising the cigarette taxes will affect smoking;

- Stephanie Epperson explored the relationship between economic freedom and happiness;
- Henry Hildebrand considered the role of overconfidence bias in the student loan default rate at for-profit universities;
- Jessica Jackson examined whether social norms were more effective than financial incentives to tackle obesity;
- Brent Laman considered whether jurors were more likely to believe, and give greater weight to, the testimony of physically attractive expert witnesses;
- Trevor McElhane and Fred Pickney took a behavioral economics approach to payday lending;
- Merrill F. Nelson, II considered the existence of Veblen effects in the Vidalia onion industry;
- Michael Stahl considered the implications of behavioral economics on program trading;
- Greg Talley explored the limitations of neoclassical economic theory in explaining racial discrimination and how behavioral economics could illuminate the discussion; and
- Alex Warner examined the infrequency of gym use and per-use gym memberships and whether gyms were intentionally exploiting consumers' bounded rationality and willpower.

The TRANSACTIONS editors selected for this Symposium two papers from my fall 2011 behavioral law and economics seminar and a third paper from the law and economics seminar of my colleague, Professor Robert Lloyd.

N. Adam Dietrich, as part of Professor Lloyd's seminar, examines regulatory capture in his article, *BP's Deepwater Horizon: "The Goldman Sachs of the Sea,"* and how the oil and gas industry effectively captured the federal agency charged with regulating offshore drilling in the outer continental shelf. Using the recent BP oil spill, Adam explores the factors that contribute to regulatory capture and the extent to which the BP oil spill is the result of the failures of big government. One important factor, Adam points out, that made the federal agency susceptible to industry influence, and ultimately a victim of regulatory capture, was the gradual degeneration of the agency's ethical culture.

Grant Marshall, in his article, *Hold the Mayo: Why Strong Deference to Treasury Regulations Might Not Be Healthy*, raises an interesting issue, namely whether behavioral economics applies to governmental agencies. If firms and individuals suffer from biases and heuristics, can governmental regulations also reflect (perhaps to different degrees) these biases and heuristics? If so, to what extent should courts defer to the agencies' expertise? Moreover, Grant explores how administrative law (and the degree of judicial deference) can be used to debias agency decision-making.

Tyler Morgan, in his article, *The Refinancing Crisis in Commercial Real Estate: Dodd-Frank Threatens to Curtail CMBS Lending*, takes a behavioral economics perspective on the subprime home mortgage crisis. He then examines whether these concerns translate to the commercial mortgage-backed securities (CMBS) market. Tyler argues that the policy concerns behind the risk retention and mandatory disclosure requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act do not exist in the CMBS market. Whereas behavioral economics plays a role in one industry, Tyler discusses, it does not necessarily affect other related industries.

The aim of the behavioral law and economics seminar and of this symposium is not to hail behavioral economics as the elixir for today's prevailing policy issues. Instead the aim is to provide a glimpse of some of the current issues that our law students are tackling in re-examining basic behavioral assumptions.

