

explanation of the benefits of promissory institutions. But will theorists do not have recourse to this kind of explanation, and their abstract defense of promising is unable to provide an answer to this challenge.

A final difficulty with will theories, in all their forms, is that they seem unable to explain the content of contract law. In one respect they are superior to reliance and benefits theories, since the Hegelian contract is binding when made, whether or not reliance or benefits claims will lie. But for other kinds of contract rules will theories are silent. They do not explain how a court might arrive at a set of implied terms when there is a gap in the express terms. For example, when the contract does not explicitly specify any warranties as to quality, and the goods are not supplied on an "as-is" basis, a court will imply a warranty that the goods be merchantable. Such warranties might serve efficiency goals, and be explained on an economic analysis of contract law. But since the parties did not come to an express agreement about the implied terms, they must be an enigma to the will theorist.²⁹

Summary

In addition to law-and-economics theories, there are three rival explanations of promising and contract law: reliance, benefits and will theories. Reliance explanations would ground liability for the promisor's breach on the promisee's detrimental reliance. However, such theories cannot explain why the institution of promising should exist and suggest instead that we should ban promising altogether. Reliance theories also suffer from an inability to explain why the unrelieved-on promise should be binding, and are therefore unable to account for a fundamental feature of contract law. Benefits theories give promises a restitutionary remedy when the faithless promisor retains the benefit of a contract and omits to perform, himself. Once again, this suggests a reason to ban the institution of contract law as a trap for the unwary. It also fails to explain why contracts are binding before anyone had begun to perform and no benefits have been conferred. Finally, will theories do not explain why promises and contracts are binding and are unable to account for basic contract law rules such as the law of implied terms.

For a satisfactory explanation of these problems, we must turn from reliance, benefits and will theories to the law-and-economics account of contract law.

3 The economic theory of contract law

To breed an animal capable of promising – isn't that just the paradoxical task which nature has set herself with mankind, the peculiar problem of mankind?

Nietzsche, *On the Genealogy of Morals*

We are now in a better position to evaluate the foundational questions of contract theory and to recognize wrong turns. It is very much a wrong turn to begin by asking why promises are binding. That is simply the way that the institution works; it is what it means to promise. As John Rawls noted, asking why that should be the case is like asking why batters do not get four strikes.¹

Instead of asking why our promises and contracts are binding, the first question for contract theory is why such institutions are valuable. Why might members of a non-promissory society wish to adopt them, could they somehow be given the choice? Why is contract law a more valuable institution than, say, baseball? The answer is trust. What the institutions of promising and contract law crucially supply is the element of trust which makes promises credible and which permits promisees to rely on promisors. Without the trust created by contract law, opportunities for gain from joint projects would be lost and our society would be poorer.

An institutional perspective is necessarily a consequentialist one. We cannot evaluate the costs and benefits of adopting an institution without looking at the consequences of doing so. This is not to say that only narrow economic consequences count and that broader social considerations are ruled out of order. If the material benefits from contract law were somehow exceeded by the social costs of a coarser and more grasping society, the consequentialist would oppose its adoption, as would the economist. All consequences matter, even though problems of quantification make comparisons difficult. For now we assume that contractual regimes are benign and defer an examination of contract law's spillover effects until Chapter 9.

The need for trust

As we saw, Hume pioneered the institutional analysis of promising. In his analysis of bargaining, he was also one of the earliest economists, and several of Adam Smith's key insights may be traced back to him. In particular, the discovery that specialization of trade promotes economic growth should be attributed to Hume, who noted that "different men are by nature fitted for different employments, and attain to greater perfection in any one, when they confine themselves to it alone."² With economies of specialization the baker can restrict his business to bread-making; he can buy his flour from merchants and need not grow and mill his own grain. But he cannot do so unless he can trust the merchant to supply him with flour when he needs it. Without trust, the parties cannot rely on each other, and are driven back to producing all their own goods and foregoing the gains from specialization.

To illustrate the need for trust Hume took the example of two farmers who need to cooperate to exploit a bargain opportunity over future crops:

Your corn is ripe today; mine will be so tomorrow. 'Tis profitable for us both, that I shou'd labour with you to-day, and that you shou'd aid me to-morrow. I have no kindness for you, and know you have as little for me. I will not, therefore, take any pains upon your account; and should I labour with you upon my own account, in expectation of a return, I know I shou'd be disappointed, and that I shou'd in vain depend upon your gratitude. Here then I leave you to labour alone; You treat me in the same manner. The seasons change; and both of us lose our harvests for want of mutual confidence and security.³

The opportunity for gain is before their eyes; yet the farmers cannot grasp it without the institution of contract law to solve the problem of trust.

Why would the parties pass up an opportunity for joint gains which would make them both better off? The answer is that what might make the parties jointly better off when they cooperate might not give each as much as he could have without cooperation. That is, what is collectively rational might be individually irrational. To see this, it is helpful to model the bargaining problem as a Prisoners' Dilemma game.

Table 3.1 The Promisor's Dilemma: how profitable joint opportunities may be lost because of individual incentives to defect

		Player Two	
		Cooperate	Defect
Player One	Cooperate	3, 3	-1, 4
	Defect	4, -1	0, 0

In the model, bargaining is seen as a two-person game, in which the outcome or payoff for each party is dependent not only on what he does but on what the other party does. The payoffs available to the parties are, therefore, represented as four possible outcomes in a 2×2 table (see Table 3.1). The first figure in each box indicates the payoff to Player One, and the second the payoff to Player Two, with the numbers arbitrarily selected to make a point about the gains from cooperation and the ways these might be lost through individual incentives to breach.

When both parties cooperate (the upper-left hand box), each promises and performs his promise and each receives a payoff of 3; when both defect (lower right), they fail to enter into a contract and receive 0 apiece. Where Player One cooperates and Player Two defects (upper right), or where Player One defects and Player Two cooperates (lower left), the cooperating party promises and performs and the defecting party promises and breaches. The seller delivers but is not paid; or the buyer pays but does not receive the goods.

Joint cooperation is the efficient (highest total payoff) solution, as the total gains of $(3 + 3 =) 6$ exceed the total gains from any other strategy. With joint defection $(0, 0)$, the parties wastefully pass up the bargaining gain. However, each party will prefer this to the situation where he performs and the other party defects. In that case, the performing party gets -1 (the "sucker's payoff") while the breaching party gets 4 (the "opportunist's payoff").

If joint cooperation is socially efficient, why would a party defect? The answer is that each party's private incentives are imperfectly aligned with their joint interests. Considered together (and summing both payoffs in each box), the two parties are best off when both cooperate; but considered individually, each is better off when he defects and gets the opportunist's payoff. In the upper-left box, Player One can increase his payoff from 3 to 4 by defecting; in the upper-right box, he can increase his payoff from -1 to 0 by defecting. Player Two can increase his payoffs in the same way through defection, moving from the upper-left to the upper-right box, or from the lower-left to the lower-right box. Whatever one party does, the other is always better off if he defects. For both parties, defection beats (dominates, in the language of game theory) cooperation in every state of the world. The logic of the game implies that the parties will both defect, ending up in the lower-right box where the contractual gains are lost.⁴

The nature of the game would change if the parties could enter into enforceable contracts with each other to cooperate, as this would change the payoff structure. For example, defectors might be required to pay damages equal to the amount of the other party's losses, which would remove the temptation to defect (see Table 3.2).

Table 3.2 is Table 3.1, with the difference that defectors are required to pay cooperator's damages of 3 for their lost profits. Here, the parties

Table 3.2 The Promisor's Dilemma after private contracting: where the defector is liable in damages for lost profits

		Player Two	
		Cooperate	Defect
Player One	Cooperate	3, 3	2, 1
	Defect	1, 2	0, 0

are always better off when they cooperate, and their private incentives are fully aligned with their joint interests. As such, neither will defect.

The Prisoner's Dilemma game illustrates how profitable joint opportunities may be lost when contracts are not enforced. When the buyer pays the price and the seller refuses to deliver, or when the seller delivers and the buyer refuses to pay, the party in breach gets the opportunist's payoff and the innocent party gets the sucker's payoff. Future parties will anticipate this and refuse to enter into agreements. The result is a settled pattern of defection and mistrust in which bargaining gains are abandoned, unless the parties can bind themselves through enforceable bargains.

Beneficial reliance

When the parties refuse to rely on each other's promises, the bargaining loss can usefully be explained through the economist's indifference curves. An indifference mapping also highlights the deficiencies in the reliance and benefits explanations of contracting.

When presented with a choice between different goods (represented along axes of a diagram), a consumer will find himself indifferent between various bundles of goods. He might find that five apples and three oranges are just as good as four apples and four oranges. Or ten apples and no oranges. The line that connects all the points of indifference between one combination of goods and other combinations is called an indifference curve.

For our purposes, let us assume that the two goods are consumption today and consumption tomorrow of money. The indifference mapping will indicate the consumer's preferences as between present and future consumption.

In Figure 3.1, the consumer is given \$100 which he must spread over two time periods. The straight line between consumption of \$100 in the two periods is called the *budget line* and represents every possible combination of present vs. deferred consumption, given the consumer's fixed amount of money. The frugal ant takes a position at one extreme, saving in the present and spending the entire amount in the second period; while the grasshopper lives solely for today and spends the entire amount in the present period.

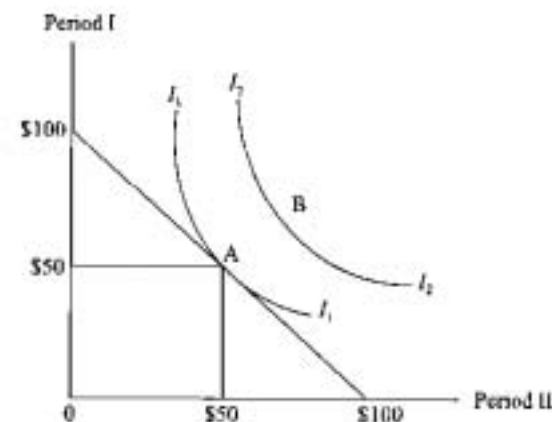


Figure 3.1 The saving decision

At the point of origin the consumer has no goods of either kind. We assume that he always wants more goods and that he will always prefer to be on the highest indifference curve (the one furthest from the point of origin). Given the choice between curves I_1 and I_2 , he would, therefore, prefer to be on the latter. As this lies above the budget line, however, it is not a feasible outcome. He simply doesn't have the money. Instead, curve I_1 , which is tangent to the budget line at the point of intersection, represents the highest feasible indifference curve available to the consumer with a \$100 budget and, as it happens, this assumes equal consumption in the two periods, \$50 now and \$50 later.⁵

Charles Goetz and Robert Scott have employed an indifference curve model to explain how trust benefits bargainers (see Figure 3.2).⁶ Suppose that our subject – call him David – begins with an endowment of \$100 and reaches his highest feasible indifference curve at point $A_{50, 50}$, where he consumes \$50 now and \$50 later. David's Uncle Ebenezer tells David he wants to give him another \$100. If Ebenezer makes the gift in the first period, we assume (arbitrarily) that David will move to point $B_{100, 100}$, again dividing consumption equally in the two periods. However, Ebenezer does not have the \$100 in period 1, and can only promise to give David the money in period 2. If Ebenezer promises to make the gift and subsequently performs, and if David relies on the promise by consuming his entire \$100 in period 1 and the gift of \$100 in period 2, then David will be as well off as he would have been had Ebenezer made the gift in period 1.

Now suppose that Ebenezer promises and David relies in period 1, but that Ebenezer fails to perform in period 2. David will now be at point $C_{0, 100}$ and worse off than if he had not relied. Had he refused to trust his uncle, he would be on indifference curve I_{100} ; instead, he is now on