

**Recent Economic Thought**

# **Law and Economics**

edited by  
**Nicholas Mercuro**

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edited by  
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# 1 TOWARD A COMPARATIVE INSTITUTIONAL APPROACH TO THE STUDY OF LAW AND ECONOMICS

Nicholas Mercurio

The purpose of this chapter is twofold. First, it attempts to describe one perception—broad in scope and inclusive in nature—of the fundamental interrelations between law and economics. It is argued that this characterization can serve as a basis for building what may be termed “a comparative institutional approach” to the study of law and economics [1]. It is hoped that this characterization of law and economics will provide an umbrella framework within which the several perspectives comprising the law-and-economics movement can be better understood. Second, from the vantage point of this characterization, selective works from the literature of comparative economic systems are introduced in order to provide what appears to be a logical extension to the comparative institutional approach as one potential avenue of development in the emerging field of law and economics. Perhaps the characterization of law and economics presented here can serve as a prism to disentangle the conventional so-called “isms of standard political economy” [2].

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## 1. Introduction

The character of economic life<sup>1</sup> in a society is dependent upon, among other things, its political-legal-economic institutional setting.<sup>2</sup> Within that institutional structure, the individuals who comprise that society attempt to cooperate with one another to their mutual advantage so as to accommodate their joint utility-maximizing endeavors. In addition, these same individuals call upon certain societal institutions to adjust the conflicting claims of different individuals and groups. In this regard, a society is perceived as both a cooperative venture for mutual advantage where there are an identity of interests and, as well, an arena of conflict where there exists a mutual interdependence of conflicting claims or interests. The manner in which a society structures its political-legal-economic institutions 1) to enhance the scope of its cooperative endeavors and 2) to channel internal political-legal-economic conflicts toward resolution, shapes the character of economic life in that society.

In contemplating the structure of its institutions intended to promote cooperation and channel conflict, a society confronts several issues. At the most general level an enduring issue is how a society both perceives and then ideologically transmits (perhaps teaches or rationalizes), internally and/or externally, its perceptions of so-called "cooperative endeavors" and "arenas of conflict." There can be no doubt that the resultant structure of a society's institutions will reflect that society's perception as to what cooperation entails and what conflict constitutes. Second, and directly related to the former, are the issues of what the nature will be of the underlying constitution and what the *initial* structure will be of the institutions that will go toward shaping the character of economic life. And finally, there is the recognition that the institutions can be changed in response to economic needs of the society. The issue here then is one of how a society allows for orderly (incremental or "radical") change of its political, legal, and economic institutions.

These are the background questions underlying much of law and economics. Whether one or another political-legal-economic system (i.e., one ism or another) is seen to emerge in a society, its emergence can be interpreted, in part, as a response to this set of issues confronting it.

## 2. Stages of Choice

The selection or establishment of a specific set of institutions, and thus the character of economic life in a society, is the product of choice. With



respect to law and economics, the literature has focused attention on three different stages of choice. First, it becomes necessary to describe and understand the emergence of the most basic social contract that binds its people together. This can be termed the *constitutional stage of choice*. Second, it is necessary to describe and understand both the structuring and the revising or restructuring of the political-legal-economic institutional decision-making processes—the so-called *institutional stage of choice*. Finally, the consequent economic impacts of the prevailing or potentially revised legal relations governing society must be analyzed and understood—the *economic impact stage of choice*. In attempting to address these concerns, most of those contributing to the literature of law and economics have divided their labors to describe these three different levels of choice.

### 2.1. *Constitutional Stage of Choice*

In order to understand the nature of the choices necessary at the constitutional stage, it is useful to start in a conceptual state of anarchy. Individuals will then contemplate the opportunity costs associated with the protective-defensive resource diversions that are necessary and essential for life under a system of anarchy. Once they recognize the potential prospects for improvement in the character of their economic life brought on by establishing a social contract or constitution, they will enter into some form of social contract or formally adopt a constitution. In establishing the constitution, the individuals will seek to spell out the behavioral limits of what is and what is not mutually acceptable conduct and lay out the so-called “rules for making rules.” It must be noted that while the established constitution is typically thought to have only a subtle effect on the allocation and distribution of resources, that subtle impact cannot go ignored.

Among the decisions made at the constitutional stage of choice that ultimately affect the character of economic life is the following: the structure of the law-making institutions (e.g., one or two house legislature) will be established together with whether a majority or perhaps two-thirds vote will determine a legislative choice. In addition, since constitutions are not immutable, the methods by which constitutional rules can be revised are developed at this level of choice. Further, it should be noted that the relationships among emergent institutions are also partially resolved at the constitutional stage of choice. For instance, the choices that govern which institutions will prevail over others in

making choices (to provide a system of checks and balances) must be decided.

The essential point to be understood here is that whatever institutions come to characterize a society, they owe their development, existence, and legitimacy to the initial choices made at the constitutional stage of choice. Once the constitution is framed, it will then provide the basis for the emergence of a broad assemblage of legal-economic institutions— institutions that will more directly affect the allocation and distribution of resources in society. The structuring of these legal-economic institutions constitutes the *institutional stage of choice*.

## 2.2. *The Institutional Stage of Choice*

The institutional stage of choice focuses directly on the structure of the political-legal institutions (commonly referred to as *the state*) as well as the revision of those institutional structures. It is the specific *working rules* comprising the institutional decision-making processes that are at center stage. More often than not the decision-making processes of an institution are formally worked out by the institution itself in developing its own working rules. Examples of this might include: judiciary—rules of evidence; legislature—committee structures and procedures; government agencies—determining the procedures by which standards are arrived at (EPA, OSHA, FDA, etc.); regulatory commissions—rules governing intervenors at rate hearings for a regulated utility.

In addition, not only are the decision-making processes of a legal institution partially established by the rules worked out at the constitutional stage of choice but they are also a partial function of the decisions of other institutions often under complex procedures. An example of this would be a court decision that imposes certain restrictions or obligations upon a legislative body or government agency. As in the case of constitutions, legal institutions are not set in stone, but rather are themselves a response to economic needs and, as such, can and do undergo structural revisions. Changes in the working rules of a legal institution will revise the decision-making processes of that institution and, as a result, may alter the institutional choices that directly impact the legal relations governing a society, that is, the extant structure of property rights. It is these choices as to the structure of property rights to which I now turn by exploring the economic impact stage of choice inasmuch as it is this stage of choice that comprises the most prominent interface between law and economics.

### 2.3. *The Economic Impact Stage of Choice*

Conceptually, it is useful to begin with the notion of three distinct property right systems for organizing and controlling the allocation and distribution of resources: the market sector, the public sector, and the communal sector. Initially each sector is treated as if it exists separate and apart from the other sectors. As will be seen, typically, all three systems operate contemporaneously to allocate and distribute resources.

**2.3.1. The Market Sector.** In the pure market sector, all property rights are held privately as bundles of fee simple absolute rights. According to the conventional legal-economic definition of property rights, what individuals own are not goods or resources but the rights to use goods and resources. Armen A. Alchian and Harold Demsetz stated, "What are owned are socially recognized rights of action" [3]. Thus, as outlined by Alan Randall, in the pure market sector, property rights must have four characteristics. They must be:

1. Completely specified, so that it can serve as a perfect system of information about the rights that accompany ownership, the restrictions upon those rights, and the penalties for their violation.
2. Exclusive, so that all rewards, and penalties resulting from an action accrue directly to the individual empowered to take action (i.e., the owner).
3. Transferable, so that rights may gravitate to their highest-value use.
4. Enforceable and completely enforced. An unenforced right is no right at all [4].

With this structure of private property rights established by the individuals of a society acting through their institutions, and with a market as the system of social control, it is then possible for the individuals to further enhance their welfare by specializing and engaging in exchange through trade. This process of trade is conventionally viewed as a purely voluntary endeavor and characterizes that which takes place in the market sector. The voluntary nature of this market process is such that no individual will engage in a trade that leaves him/her worse off. The final allocational and distributional outcome will be arrived at once all the gains from trade have been exhausted. Thus, given a set of private property rights so structured and given some initial distribution of rights, barring externalities and the problem of public goods, the market outcome can be shown to be efficient (more specifically, Pareto efficient).<sup>3</sup>

**2.3.2. The Public Sector.** The public sector is yet another arena for organizing and controlling the allocation and distribution of resources in a society. In this idealized sector the allocation and distribution of all resources will be determined through the public sector. That is, in response to the individuals who comprise the society, the institutions will define and assign status rights which are, in effect, eligibility requirements for individuals to gain access to goods and resources. Status rights are rights to goods or resources which are exclusive, nontransferable, and provided to individuals via the state [5]. Thus, the provision of status rights may be conceived of as "government regulation" in its broadest sense. As such, political-legal institutions are understood to make a broad spectrum of decisions that give rise to status rights. For example, status rights emerge through judge and jury verdicts, in the drafting of legislative statutes, through government agency or commission pronouncements, and through a host of other public sector actions. With a public sector as the system of social control, the emergent structure of status rights has a direct impact on the allocation and distribution of resources.

**2.3.3. The Communal Sector.** In a similar manner, individuals of a society, acting through institutions, may decide that commodities or resources will be communally owned and hence equally available to all (i.e., nonexclusive) and nontransferable. In this case, rights would be assigned equally to each individual, resulting in a communal allocation and distribution.

### **3. The Complex Legal-Economic Arena**

Typically, a society is structured so that the character of economic life is determined by all three systems of social control: the market sector, the public sector, and the communal sector. The relative scope and content of each of the systems of social control is the result of a collective determination of those who prevailed in choice-making processes in the political-legal-economic arena (see figure 1-1).

Members of society, acting both individually and collectively, will endeavor to revise the constitution, to structure and restructure the institutional working rules, and to alter the property rights (be they private, status, or communal) in the market, public, and communal sectors in order to achieve an allocation and distribution of resources that enhance their individual welfare. This is accomplished under the recognition that neither 1) the constitution, 2) the decision-making processes of

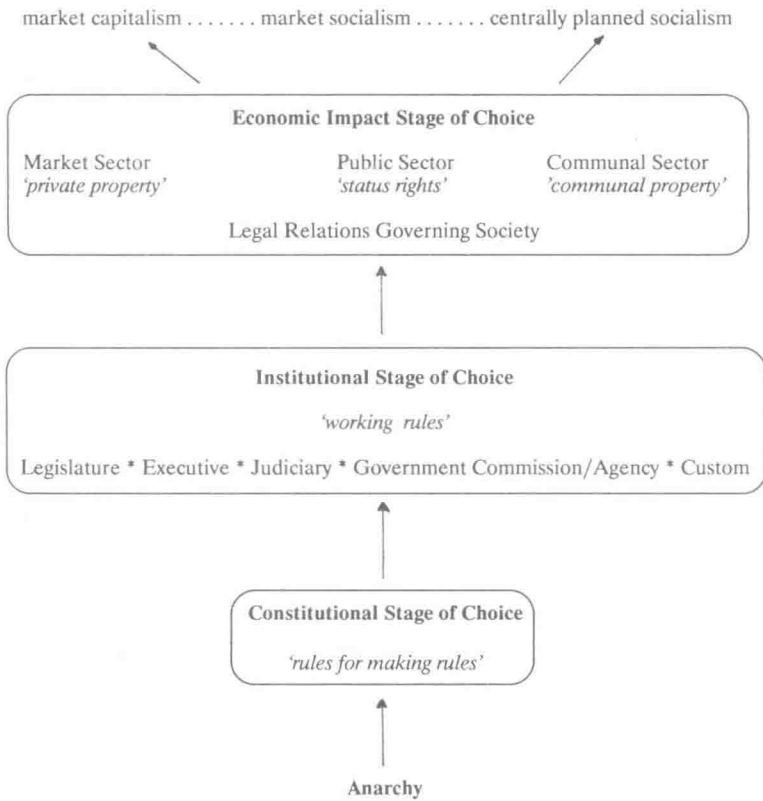


FIGURE 1–1. This diagram integrates the three stages of choice—the constitutional, institutional, and economic impact stage together with the market, public, and communal sectors. The participants in the political-legal-economic arena will (from the bottom up) establish a constitution; they will set in place working rules in structuring their legal-economic institutions; and they will structure the legal relations governing society—private property rights, status rights, and communal rights, respectively giving rise to the private, public, and communal sectors.

the legal institutions (i.e., the working rules), nor 3) the legal relations governing the size and scope of the market, public, and communal sectors are given immutably by nature but are themselves a response to economic needs and flexible in response to changes in those needs.

It should be noted that the particular construction set forth in this section parallels that which Walter Ullmann has described as “the ascend-

ing theme of government and law" [6]. He traces the origins of this conception to the late thirteenth century. It is a conception of government and law where the individual is perceived as sovereign—not as a mere subject but as a citizen—and where the government and law owe their legitimacy to the *consent* of the sovereign individuals. With greater robustness, Thomas Hobbes and John Locke, latter in the seventeenth century, developed a parallel conception of government and law wherein the principal function of the government was seen to be, among other things, to protect the purported "well-settled" sovereign natural rights held by individuals.

While the characterization of law and economics described in this section more or less follows the general contours of the ascending theme of government and law, it is not the only theme that can describe the origin and thus legitimacy of the prevailing constitution and government institutions. Ullmann also presented what he termed the "descending theme of government and law." His characterization purports to describe much of pre-late thirteenth century Europe. As elaborated upon by James S. Coleman [7], this conception is not unlike the ideas of rights and sovereignty latter developed by Jean-Jacques Rousseau and Karl Marx. The descending theme of government and law suggests that sovereignty is located in the state with government there as the collective instrument to implement the will of society. If founded in this manner, then the constitution and government institutions gain their recognition and legitimacy accordingly. It should be noted that while the argument throughout the first section implies some form of democratic government, perhaps more consistent with Ullman's "ascending theme," the essential point—that the institutions have a direct impact on the allocation and distribution of resources—is equally valid with respect to choices made by institutions of nondemocratic, coercive governments.

It is important to understand the nature of the choices made at the constitutional, institutional, and economic impact stages of choice. Specifically, at the constitutional stage of choice, it is the "rules for making rules" that will undergo revisions. Further, working through the institutions, at the institutional stage of choice individuals restructure institutions by altering working rules, whereas at the economic impact stage of choice, they work to revise property rights. In one capacity or the other, they ultimately alter the legal relations among members of society and thereby redetermine (perhaps only incrementally) the relative scopes of the market, public, and communal sectors in the society.

Some specific examples may help to understand further what is at issue here. While at the constitutional stage of choice the basic elements of the social contract may be altered, at the institutional stage of choice, indi-

viduals may try to 1) revise rules for determining legislative committee structures; 2) determine the criteria as to who may have standing in a court of law or raise or lower the maximum limits for litigation in a small claims court; 3) expand or limit the role of the intervenor at rate hearings; 4) alter the criteria and/or the process by which pollution permits are obtained; and 5) broaden or curtail actions that come under the notion of executive privilege.

The nature of the choices are different at the economic impact stage of choice. Here individuals may work to: 1) determine which goods, services, and resources will be directly under the state's supervision (e.g., more or less public or private education); 2) determine status rights by defining specific eligibility requirements for individuals to gain access to certain goods or resources (e.g., healthcare, welfare, foodstamps, etc.); 3) enhance or diminish the scope of (a) residential, commercial, and industrial zoning restrictions, (b) blue laws, or (c) price supports and price ceilings; 4) have specific rate structures adopted at public utility hearings; 5) have a parcel of land made readily available for private development or have the same parcel declared communal property for conservation or wilderness purposes; 6) either assign the right to an upstream chemical firm which allows it to dump its residuals into the stream or assign the right to the downstream farmer who uses the water for crop irrigation to have unpolluted water available; and 7) have environmental commissions either closely monitor and strictly enforce standing environmental laws or rarely monitor and thus loosely enforce the same laws.

These examples are intended only to illustrate that individual participants in the political-legal-economic arena can restructure their constitution, their institutions, and work to revise property right structures through the prevailing institutions and thereby reshape the ultimate character of economic life. As will be seen in the comparative economic systems literature (in a latter section), taken together, the emergent private, status, and communal structures of rights—the property rights—will comprise one of the four fundamental characteristics—the power structure, mechanisms for coordinating information, property rights, and incentives—of the three stylized *political-economic systems*—market capitalism, market socialism, and centrally planned socialism (top of figure 1-1).

#### 4. Necessity of Choice

Whether at the constitutional, institutional, or economic impact stage of choice, the emphasis here is on the continuing necessity of choice—the

fact that there are no neutral principles to which society can turn in making political-legal-economic choices. Making choices means the introduction of values. One may observe in a society that *the* dominant system of social control to allocate and distribute that society's scarce resources is the market sector, or the public sector, or the communal sector. The essential point to be understood is that whichever one is chosen (or, more realistically, whatever relative mix obtains), the outcome is to be seen as an expression of the values of those who have participated and prevailed at each stage of choice in the political-legal-economic arena.<sup>4</sup> The necessity of choice has been recognized by many. In writing on the institutional level of choice James M. Buchanan states:

Man must look to all institutions as potentially improvable. Man must adopt the attitude that he can control his fate; he must accept the necessity of choosing. He must look on himself as a man, not another animal, and upon "civilization" as if it is of his own making [9].

Warren J. Samuels, in writing on the interrelations between legal and economic processes, also states:

There is, first of all, an existential necessity of choice over relative rights, relative capacity to visit injury or costs, and mutual coercive power (or claims to income). The economy, in which the legal process is so obviously involved, is a system of relative rights, of exposure to costs shifted by others, and of coercive impact of others. . . .

If the issue is one as to which interest government will be used to support, part of the character of the legal process is clarified. The legal system (government, law) is not something given and external to the economic decision-making process. Rather, since government is a mode through which relative rights and therefore relative market (income securing) status is given effect, the critical question is *who* uses government for *what* ends. . . .

Simply put, the question of whose interests the state will be used to effectuate reduces in part to the question of which specific interests or values will dominate in a particular case. This ultimate specificity of choice is the existential burden of man, which no reference to general or neutral principles or choices will avoid [10].

Perhaps Kendall P. Cochran expresses it best. In writing on the necessity of moral assumptions in shaping the future character of economic life, he states:

In sum, man, as a social being, has a degree of control over his future destiny. Today and yesterday are *irretrievably* gone. But the future can be of his own making. If one were to take a purposeful, a moral look at the future and ask himself, ask his generation, "What do we want to do with it?" he would find



that meaningful alternatives were available. But only if we make a clearly defined choice regarding the moral assumption we choose to use. And that is the moral imperative for members of the economics profession. The only alternative is one of laissez-faire indifference. And the consequence of that moral position, for laissez-faire indifference is equally a moral position, will be that meaningful alternatives are not made available and known to society [11].

## 5. Toward a Comparative Institutional Approach

Given the necessity of choice, the problem then becomes one of choosing the “appropriate” institutional arrangements or rearrangements for shaping the character of economic life. That there exist competing theories (economic as well as noneconomic) to prescribe the “appropriate” institutional arrangements is incontrovertible [12]. Utilizing the characterization of the interrelations of law and economics as summarized in figure 1–1, one approach—what be termed a *comparative institutional approach*—emerges. It is based on the belief that systematic relationships exist between legal institutions and the character of economic life. The scope of the comparative institutional approach is then to describe and analyze the systematic relationship between 1) the structure of political-legal-economic institutions, focusing on the rights and rules by which they operate; 2) the conduct or observed behavior in light of the incentives (penalties and rewards) created by the structure of the institutions; and 3) the consequent economic performance, i.e., the allocation *and* distribution of resources that determine the character of economic life under those institutions.<sup>5</sup>

This is not unlike what has been proffered by some of the contributors to the law and economics literature. In one of the least celebrated passages of one of the most celebrated law and economics articles, Ronald A. Coase suggested that, notwithstanding his predisposition to the market sector:

The discussion of the problem of harmful effects... has made clear that the problem is one of choosing the appropriate social arrangement for dealing with the harmful effects. All solutions have costs and there is no reason to suppose that government regulation is called for simply because the problem is not well handled by the market or the firm. Satisfactory views on policy can only come from a patient study of how, in practice, the market, firms and government handle the problem of harmful effects... It is my belief that economists, and policy-makers generally, have tended to over-estimate the advantages which come from governmental regulation. But this belief, even if justified, does not