The Economic Approach to Law

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The opinions expressed by us in the Introduction should not be attributed to the contributors, although we believe that there is *some* overlap between our view of law and economics and theirs.

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CHAPTER ONE

Introduction: the economic approach to law[1]

Paul Burrows and Cento G. Veljanovski

A major development in North American legal scholarship over the last decade has been the increasing use of economics. This is evident not only in the type of article that is finding its way into legal journals but also in the teaching of law in some universities, in the appointment of full time economists to law schools, and more recently in the establishment of research centres in law and economics[2]. In Britain the situation is quite different, although there are signs that the study of law and economics is beginning to develop[3].

While the economic approach to law has firmly established itself in North America it has not been without its critics (e.g. Leff, 1974), some of whom have been hostile to the whole idea, whereas others have objected to the particular variety of law and economics known as the 'Chicago approach'[4]. 'Economic analysis of central legal issues', observes Krier, 'seems to forment storms where otherwise mild breezes blow' (Krier, 1974, p.1665). While some of the criticisms constitute attacks on economics in general, rather than specifically on its application to law, others draw attention to problems that the economic approach to law has encountered and that have been ignored or inadequately treated by those doing research in this area.

The purpose of this introduction is to examine the present state of the art and to draw attention to the strengths and weaknesses of the economic approach to law[5]. We would emphasize that the critical perspective adopted here is not intended to imply that the economic approach has failed; rather it is motivated by the belief that any new intellectual endeavour is enhanced rather than retarded by moderately critical appraisal[6].In law and economics the endeavour hinges on the expectation among both lawyers and economists that the disciplines are complementary and that collaboration is potentially fruitful. It is a sustainable point of view that such collaboration will ultimately be discouraged if an influential group of the practitioners of one of the disciplines is apparently intent on the hard-sell, on adopting a colonizing posture to bring the 'right' methodology to those unfortunate enough not to have been born with it, or at least to have been weaned on to it at an early age. The danger of the hard-sell is that the potential buyers will divide into one group which rapidly loses interest in the collaborative endeavour, and another which succumbs and adopts the typically uncritical attitude of the new convert, the born-again economist. It is difficult to say

which of these two reactions is likely to be the more damaging to the progress of law and economics.

Our intention is first to introduce the reader who is unfamiliar with the economic analysis of law to the central tenets of the analysis and its main applications, and secondly to describe the main trends in the literature and to highlight the difficulties that are encountered when lawyers use economics to provide descriptive theories of the law.

This introduction is organized as follows. Section 1.1 outlines the positive and normative types of economic analysis, and section 1.2 compares the main advantages and disadvantages of the economic studies of law. Section 1.3 concentrates on recent attempts by lawyers to use economic theory as a basis for a descriptive theory of law. The difficulties which this theory of law involves justify the examination, in section 1.4, of an alternative methodology for the descriptive theory of law. Section 1.5 briefly mentions some recent developments in the use of economics to evaluate the operation of statutory controls in areas of the law that hitherto have not been subject to such scrutiny.

1.1 The economic approach to law

1.1.1 Basic ideas in the economics of law

The marrying of economics and law is not new. 'Economic' approaches can be found in the works of Beccaria-Bonesara (1764), Bentham (1789), Marx (1867) and in the turn-of-the-century work of the American Institutionalist school, particularly the writing of Commons (1924). For a considerable period (1920–1960) the economic study of law and institutions fell into disrepute, although the intersection between law and economics continued in areas where the law had obvious economic objectives and/or effects, e.g. antitrust, competition and trade policy and regulation. The resurgence in the economic analysis of law came from a number of sources. The work of Becker (1957) on discrimination, although not specifically law related, provided the initial step in generalizing neoclassical economics to non-market behaviour. The early work of Alchian (1961) and Demsetz (1969) on property rights, Calabresi (1961) on tort, and Coase (1966) on nuisance represent the building blocks on which the new law and economics now rest. Mention should also be made of the *Journal of Law and Economics*, which, under the general editorship of Ronald Coase, provided an outlet for much of the new work in the field[7].

The 'new' economic approach to law differs from its precursors both in the rigour of its theoretical approach and in its subject matter, namely non-market law[8]. Economics has been increasingly applied to a variety of non-market activities, ranging from rioting (Chalmers and Shelton, 1975;

Buchanan, 1971), church attendance (Azzi and Ehrenberg, 1975) and suicide (Hammermesh and Soss, 1974) to abortion reform (Deyak and Smith, 1976; Coelen and McIntyre, 1978), the family (Becker, 1976), marriage (Becker, 1973), divorce (Becker, Landes and Michael, 1977; Landes, 1978) and extra-marital affairs (Fair, 1978). The economic approach to law is part of this wider development which has resulted from the belief held by some (but not all) economists that the core of economics, the theory of choice, is in principle applicable to all human and institutional behaviour[9]. As Robbins (1932) states 'when time and means for achieving ends are limited and capable of alternative applications, and the ends are capable of being distinguished in order of importance then behaviour necessarily assumes the form of choice . . . it has an economic aspect'[10]. The restriction of economics to the study of prices, money and material welfare no longer applies, although the study of this subject matter in the past has contributed to the growth of economics as 'science' and will continue to do so in the future. Contemporary economics is probably better described as a methodological approach than as a discipline defined by its subject matter.

The basic ideas contained in the economic approach to law are those of maximizing behaviour (utility maximization), stable preferences and opportunity cost[11]. The economic approach takes the individual as the basic unit of analysis and pictures him as a self-interested egoist who maximizes utility. Its assumptions of utility maximization and rationality have given rise to much criticism and confusion. When an economist says that an individual is acting rationally or maximizing his utility he is saying no more than that the individual is making consistent choices, and that he chooses the preferred alternative(s) from those available to him. The modern economic theory of utility/rationality attempts to describe rigorously the choice process and to draw out the implications of that process for behaviour under different conditions. It does not attempt to explain why individuals prefer particular things, or to show that the choices made are 'good' in any other sense than as subjectively assessed by the individuals concerned[12]. That is, the individual is regarded as the best judge of his own welfare, and tastes are assumed to be given and stable. The latter assumption prevents the economist from using taste changes to rationalize observed inconsistencies between theory and experience.

The economic approach does *not* contend that all individuals are rational nor that these assumptions are necessarily realistic. The economist's model of man as a rational actor is a fiction, but one that has proved extremely useful in analysing the behaviour of groups. Although much of economics is framed in terms of individual behaviour there is no belief among economists that all people behave in this way. Rather 'economic man' is some weighted average of the individuals under study in which the non-uniformities and extremes in behaviour are evened out. The theory allows for irrationality but argues that *groups* of individuals behave as if their members are rational.

Related to this 'as if' approach is that the utility maximizing postulate is not one concerned with the psychology of man or his actual thought process. It does not assert that individuals consciously calculate the costs and benefits of all actions, only that their behaviour can be explained 'as if' they did so. Admittedly this is not the only view of rationality[13], but it is the one that forms the basis of what will later be referred to as positive, or predictive, economics.

A corollary to the rationality postulate is that individuals react to changes in the net benefits received from the alternatives which confront them. In their market activities individuals are assumed to trade with each other in order to maximize their perceived welfare, and this trading will cease when all have achieved the best they can do given their initial endowment of resources and innate talents. If there is a change in the net benefits of the various alternatives available, then rational individuals will respond by acquiring more of those goods which have become relatively cheaper and fewer of those which have become relatively dearer. This inverse relationship between the price (cost) and the quantity demanded of a good is perhaps the most frequent prediction of economics.

Perhaps the most pervasive notion in economic theory is that of opportunity cost. This says simply that the use of resources for any purpose incurs a cost which is equal to the value of the best forgone alternative use. This cost is clearly fundamental to the choice between competing uses for resources, and it is equally central to those choices which are made through market transactions and those made through non-market operations. The emphasis placed by economists on the need to make choices based upon opportunity cost is not, therefore, to be thought the same as an insistence on the relevance or importance of markets. An analysis of public sector decision-making, for example, might well eschew any significant reference to markets, yet it would be based on the characteristics of non-market choices and costs. The relevance of this point to the economic analysis of law is that it means that it is consistent to argue that *any* law is likely to have economic implications (if only because the imposition of a law involves resources) even if it bears little relation to market activities and relates to behaviour that is not at all similar to market behaviour. It emphatically does not mean, however, that it is necessarily fruitful to describe non-market behaviour in terms of the language of a market analogy. For example, it is undoubtedly true that the enforcement of the law against rape involves the use of scarce resources which have alternative uses. It is also true that when a decision is made as to how many resources should be devoted to such enforcement, either implicitly or explicitly a comparison is being made between that use and alternative uses of those resources. In addition, a decision must be made on the most effective way of utilizing the resources that are to be devoted to the enforcement of the law against rape. These are issues into which economic analysis can provide some insight. But this does not mean that the lawyer-economist is well advised to view rape as a 'transaction', the penalties

for rape as 'the price the law sets for participating in the transaction as a rapist', or the ideal penalty as 'the optimal pricing scheme which balances the social benefits and costs of the activity and clears the market for rape'. When it comes to winning friends and influencing people some economists have a good deal to learn!

In some legal contexts, of course, market behaviour is very relevant to the impact of law simply because the law regulates market behaviour. Thus, it is hard to gain an insight into the implications of contract law without an understanding of the market context of contract formation. In the analysis of markets economists have found a concept of equilibrium helpful to the task of predicting the consequences for market outcomes of changes in the attitudes of the participants, as well as of changes in the legally determined rules of the market game. In an ideal market competitive pressures ensure that goods are produced at least cost and the market is cleared at a price that reflects the marginal costs to society of their production. The function performed by prices is to clear the market by making participants' plans mutually consistent (equilibrium) and to signal to producers and consumers the need to change their actions when supply and demand are not in balance. Price is, from an economic perspective, solely an allocative device that provides information to the market, and in equilibrium the economic value (price) of a commodity will equal its opportunity cost[14].

There are two other features of the economic approach. First, it is a marginal approach, it is concerned with analysing incremental changes in a system that is otherwise stable. It therefore cannot deal with dramatic changes in legal/social systems. But once the change has occurred, economic marginalism can again be used to examine the efficiency of incremental legal/social changes from the new status quo. Secondly, it is an *ex ante* approach. It focuses on incentives and on people's predicted responses to changes in the law given their expectations for the future. This is best illustrated by the way uncertainty is incorporated into economic models. Individuals are assumed to maximize their expected utility on the basis of their beliefs about uncertain events. On the basis of these beliefs individuals will make choices that *ex ante* will be efficient but *ex post* may not be if beliefs are not confirmed by experience. The *ex ante* nature of the economic approach is perhaps the major difference between it and orthodox legal analysis which looks at past events and actual cases i.e. is an *ex post* approach. For the economist the past is a 'sunk' cost and he views the law as an incentive system affecting future actions.

1.1.2 Positive economic analysis

Building upon this basic framework, economics can be divided into two traditions of discourse, positive and normative analysis. Positive economics views economics exclusively as an empirical science[15]. It is based on a

methodology that sees economic analysis solely as a means of deriving a set of testable (i.e. potentially refutable) predictions that can be verified by empirical evidence. This approach judges the usefulness of a piece of analysis (or model) by its ability to predict the behavioural responses to a change in the situation under investigation more accurately than any competing theory. If the model is successful in predicting then the negative judgment can be made that the model has not been falsified and is preferable to those that have been falsified. Positive economic analysis is therefore used largely to make qualitative predictions and organize data for the empirical testing of these predictions.

The predictions of positive economic models must be interpreted with some care. First, such models only establish partial relationships. For example, one of the most common predictions in economics is the inverse relationship between the price of a good and the quantity demanded. However, the statement must be read with an important caveat; it says that in practice the quantity demanded will decrease as price increases only if all other things remain constant in the system. Thus the predictions of positive economic models are in the nature of conditional statements 'if A — then B, given C', but B may never be observed to occur because other influences (C) have also changed. Secondly, the *partial* nature of the model does not imply that the relationships studied are the most important ones. An economist may argue, for example, that people will respond to cost-pressures (such as liability for damages) in the care they take in an activity which places others at risk, and he may empirically establish this proposition. But this is not to say that pecuniary incentives are the only, or even the best, means of achieving an increase in the level of safety.

The methodology of positive economics as described above is one that lawyers find difficult to accept. The main criticism which they are inclined to make is that the models are too simplistic and do not capture the full complexity of the legal phenomena which they seek to explain. This view usually expresses itself in the form of an attack on the unrealistic assumptions of the economists' model. In response, the economists will argue that models are by their nature 'unrealistic' — they are abstractions from, not descriptions of, reality — and that furthermore, it is not the model's assumptions that are to be verified but its predictions. We shall argue in section 1.3 that the force of this criticism, and of its rebuttal, depends on the intended use of the model.

The techniques of positive economics are most relevant to *legal impact studies* or what Hirsch has called 'effect evaluation' (Hirsch, 1979, p. 6). Legal impact studies seek to identify and quantify the effects of law on measurable variables[16]. A good, though not uncontroversial, example of this application is the positive economic analysis of crime[17].

The economic analysis of crime treats the decision to engage in crime as an example of occupational choice[18]. An individual participates in criminal

activity because it provides a greater stream of net benefits than any alternative legitimate occupation. The fundamental assumption of the economic approach is 'that offenders and those who attempt to control crime on the whole respond to measurable opportunities and incentives' (Ehrlich, 1979, p. 25). The criminal is characterized as a rational individual with stable preferences who maximizes not wealth but expected utility. It is a common misconception that the economic theory of occupational choice asserts that individuals choose jobs solely on the basis of pecuniary wage comparisons. On the contrary, the theory predicts that individuals will be influenced in their job choices by the net advantages of the jobs i.e. by the total bundle of their pecuniary and non-pecuniary characteristics. Thus the hypothesis is that the decision to engage in crime will be determined both by the wealth that can be gained and by more intangible characteristics such as the risk and life-style. Naturally the type of behaviour predicted from the economic model of a utility-maximizing potential criminal is likely to fit some types of crime better than others. For example, crimes which are substantially motivated by the prospect of monetary gain are more likely to display a pattern predicted by the maximization model than the crimes motivated by personal hatred, jealousy or lust. Even those of us who are unenthusiastic about the style of argument of this literature may concede that the only way to find out whether this is so is to test empirically the relationships predicted by the theory for different types of crime.

The principal focus of the economics literature on crime is the theoretical and empirical investigation of the deterrence hypothesis. A corollary to the economic theory of crime as a rational act is that any factor that reduces the expected return to a crime will, other things being equal, reduce the criminal's level of participation in it. The punishment meted out by the criminal law will decrease the potential criminal's expected return from engaging in a crime. The *ex ante* expected level of punishment is the product of two elements, the severity of the sanction and the frequency with which it is imposed on offenders, and the theory predicts not only that an increase in the severity or in the frequency of sanctions will decrease the number of offenders, but which of these two elements will have the greater deterrent effect.

The model of crime serves not only to provide these predictions but to organize the data to test them and is concerned with 'verifying' the deterrence hypothesis. Using sophisticated statistical techniques the evidence so far accumulated does, at least, provide tentative support for the deterrence hypothesis. A particularly sensitive area of empirical research has been the examination of the deterrence effects of capital punishment[19]. The work of Isaac Erlich has generated a considerable academic and public debate, not only because of its finding in support of deterrence but because it yields very specific estimates of the magnitude by which capital punishment reduces the homocide rate[20]. Although the debate has been vigorous

(Ehrlich, 1979, pp.50–54) it has not been about theory or approach but rather about statistical methodology, e.g. the appropriate statistical technique, the sensitivity of the results to the form of the estimating equation and the time periods chosen, and the nature of the data used[21].

To the economist legal impact studies are a natural application of economic theory and empirical methods. They ask and attempt to answer the questions: What are the likely effects of the law? Have they actually occurred? Have the objectives of the law been attained? Moreover, the economist currently has a comparative advantage over the lawyer, because of his statistical training, in answering these questions. Lawyers, when they venture into this area, all too frequently discuss the effects of law in language and arguments which are based on unsupported empirical assumptions, and their empirical research is often of dubious validity and lacks statistical rigour. But to many lawyers, the prediction and quantification of the effects of laws, while of interest, is not seen as having particular legal relevance. As a result there is a tendency to adopt a dismissive attitude to the economists' work in this area. But there can be no doubt that impact studies have an important role to play in legal analysis; for surely the law must ultimately be evaluated in terms of its success in achieving its goals, and not purely in terms of its formal legalistic structure.

1.1.3 Normative economic analysis

Normative or welfare economics is concerned with the goals of private and social allocative efficiency. The aim is to identify situations in which these are not achieved and to prescribe corrective solutions[22]. The analysis begins with the assumption that *perfectly* competitive markets achieve private efficiency, that is an allocation of resources which is efficient from the point of view of the participants in the transactions. The relationship between the market and economic efficiency is often confused. The theory does not say that actual markets are efficient, only that a market operating under a set of restrictive assumptions is. The more important of these assumptions are conveniently summarized by one standard text:

> Perfect competition is an economic model possessing the following characteristics: each economic agent acts as if prices are given, that is each acts as a price-taker; the product is homogeneous; there is free mobility of all resources including entry and exit of business firms; and all economic agents in the market possess complete and perfect knowledge (Ferguson and Gould, 1975, p.225).

It is on the basis of these assumptions that the economist's theorems concerning the private efficiency of the market and freedom of contract are based.

A privately efficient allocation of resources will imply an allocation that is efficient from the point of view of society as a whole, i.e. that will be socially efficient, only if *all* of the consequences of reallocations of resources between uses are taken into account by the participants in the transactions. In other words privately efficient allocations will be socially efficient as long as there are no external costs, or benefits, of a transaction (we shall define an external cost more explicitly below). In the absence of externalities a perfectly competitive market system is socially efficient because it 'place[s] every productive resource in that position in the productive system where it can make the greatest possible contribution to the total social dividend measured in price terms; and tends to reward every participant in production by giving it the increase in the social dividend which its co-operation makes possible' (Knight, 1935, p. 48). That is, society's resources are allocated to their highest competitively valued uses, and are sold at prices that reflect their marginal cost to society. In essence, social efficiency is a technical concept of unimprovability; there is no rearrangement of productive activity that would improve the welfare of society as measured by the competitive market place *given the distribution of income* upon which the market transactions are based (a point to which we return later).

The prescriptive ability of welfare economics is based on the concept of market failure[23]. When the assumptions underlying the perfectly competitive market are not met the market will either operate inefficiently or fail to exist. This departure from the ideal outcome of the perfectly competitive market is referred to as market failure and it provides the social efficiency rationale for legal intervention. Although market failure may result from many imperfections (monopoly, imperfect information, etc.), the most important one for legal analysis is an external cost. An external cost is an uncompensated loss that is imposed on individuals (or firms) by some harmful activity. The most significant examples of external cost relate to pollution, crime, and road accidents. The existence of external costs leads to excessively high levels of the harm-imposing activities; the socially efficient amount of avoidance or care will not be undertaken.

The existence of harmful activities is not, however, necessarily sufficient for market failure to occur. In an influential paper Ronald Coase (1960) demonstrated that perfectly competitive markets could in principle control harmful activities efficiently. Take the case of pollution. In a perfect market the loss that pollution imposes on individuals would provide them with an incentive to bargain for a reduction in its level if they had no legal rights to compensation by the polluter. If the payment offered by the victims exceeded the costs to the polluter of reducing the level of pollution then the polluter would accept the victims' payment and decrease the pollution, because this would increase his profits. Voluntary bargaining of this type would continue until all the mutual gains were exhausted, which would occur at the socially efficient level of pollution (Burrows, 1979, ch.2–3). Moreover, this