Economics and the Law

From Posner to Post-Modernism

Nicholas Mercuro
& Steven G. Medema

ECONOMICS AND THE LAW

FROM POSNER TO POST-MODERNISM

Nicholas Mercuro and Steven G. Medema

PRINCETON UNIVERSITY PRESS PRINCETON, NEW JERSEY

Preface

OVER THE LAST several decades, Law and Economics has developed from a small and rather esoteric branch of research within economics and law to a substantial movement that has helped to both redefine the study of law and expose economics to the important economic implications of the legal environment. For our purposes here, we depart from the usual more narrow definitions given to the field and define Law and Economics broadly to include the application of economic theory (primarily microeconomics and the basic concepts of welfare economics) to examine the formation, structure, processes, and economic impact of law and legal institutions. Given the fact that the law and the economy interact across a variety of fronts, the fundamental insights of Law and Economics have important implications not just for economics and law, but for other contiguous disciplines as well, particularly those branches of political science and sociology that concern themselves with various facets of the law.

The purpose of this book is to present a relatively brief overview of the core elements of the different perspectives on the varied traditions within Law and Economics. Law and Economics is not a homogeneous movement; it reflects several traditions, sometimes competing and sometimes complementary, including the Chicago School of Law and Economics, Public Choice Theory, Institutional and Neoinstitutional Law and Economics, the New Haven School, Modern Civic Republicanism, and Critical Legal Studies.

This book by no means constitutes an exhaustive survey of the contents of each of the schools of thought. In fact, its aim is more modest—to provide the reader with a synoptic, noncritical description of the broad contours of each school of thought. We do not attempt to argue for or against any particular school of thought; rather, we try only to provide a concise overview of just what each school of thought is attempting to convey, recognizing fully that the marketplace of ideas will ultimately serve as the "gatekeeper" that determines which, if any, of these schools of thought will become a permanent part of modern-day jurisprudence.

By offering a noncritical analysis and description, we hope to provide the reader with a fuller understanding of the relationships between the formation, structure, and processes of law and legal institutions and their impact on the performance of the economy. In addition, we also hope to convey a sense of the important elements of and issues between the various schools of thought, and, through this, a sense for both the importance and breadth of the interrelations between law and economy, and an appreciation of the scope of existing legal-economic scholarship.

We have benefited greatly from numerous individuals and institutions in the preparation of this book, and the sum total of these efforts have greatly enhanced its strength. We are grateful to Susan Rose-Ackerman, Peter Boettke, Thráinn Eggertsson, Dub Lane, Bill Lovett, Robin Paul Malloy, Warren J. Samuels, A. Allan Schmid, Mark Tushnet, and Gerald Whitney for their very useful comments and suggestions on various draft portions of the manuscript. Any deficiencies that remain are attributable solely to the authors.

We also gratefully acknowledge the research support given to us over the course of this project. Research support and release time for Medema was provided by the Department of Economics and W. James Smith, Department Chair; Dean Marvin Loflin and the College of Liberal Arts and Sciences; and the Graduate School of the University of Colorado at Denver. Secretarial support was provided by Lynn Ferguson, Hillary Shea, and Diane Watkins of the University of Colorado at Denver Economics Department. The research assistance of Mary Therese Cogeos is gratefully acknowledged. Margaret Henderson of East Lansing, Michigan, and David Tufte and Franklin Lopez of the University of New Orleans Department of Economics and Finance provided invaluable assistance with the preparation of the graphs. Mercuro extends a special thanks to the Chancellor, the Vice-Chancellor, and the Provost of the University of New Orleans for affording him the opportunity to annually teach *The Economics of Legal Relationships* at Tulane Law School; to the Dean of the Law School, John R. Kramer, and the faculty of the Law School for their invitation to teach the course; and, finally, to the many Tulane law students and the students of economics from both the University of Vienna and the Free University of Berlin who, over the years, have asked many probing questions that forced a valuable rethinking and reformulation of many of the ideas contained in this book.

Finally, we would like to thank the staff at Princeton University Press and, in particular, Peter Dougherty, Social Science and Public Affairs Publisher, and his assistant, Michelle McKenna, for their willingness to publish this book and for their suggestions, assistance, and encouragement in seeing this project through to completion. We would also like to thank our production editors, Sterling Bland and Molan Chun Goldstein, and our copyeditor, David E. Anderson, whose efforts greatly enhanced the quality of the final book.

Nicholas Mercuro
Steven G. Medema
November 1, 1996

Contents

ECONOMICS AND THE LAW

CHAPTER 1

The Jurisprudential Niche of Law and Economics

> It is somewhat surprising that so conspicuous a truth as the interaction of economics and law should have waited so long for recognition—a recognition by no means universal. Some of those who question it maintain the independence and self-sufficiency of law, while others maintain that of economics.
>
> In reality law and economics are ever and everywhere complementary and mutually determinative.
>
> *(Berolzheimer, 1912, p. 23)*

INTRODUCTION

The primary purpose of this book is to provide the reader with a concise overview of the dominant schools of thought within Law and Economics and the core ideas they attempt to convey. Today, Law and Economics[1] can be defined as the application of economic theory (primarily microeconomics and the basic concepts of welfare economics) to examine the formation, structure, processes, and economic impact of law and legal institutions. Various schools of thought compete in this rich marketplace of ideas, including the Chicago school, Public Choice Theory, the two institutionalist schools of law and economics (which we shall label "Institutionalism" and "Neoinstitutionalism"), and the New Haven school. In addition to examining these, we provide an overview of the principal contours of both critical legal studies and modern civic republicanism, which, although not traditionally associated with law and economics, place significant emphasis on the interrelations between law and economy and thus may be said to fall under the Law and Economics heading. As implied by the title of this book, we are presenting these schools of thought as competing perspectives or approaches within the marketplace of ideas to the study of the development and the reformulation of law and to the examination of the interrelations of legal and economic processes generally.[2] As such, these ideas are of fundamental importance for those working in the fields of economics, law, political science, and sociology.

It must be underscored from the outset that we are trying only to describe the central ideas that each school of thought is attempting to convey. No attempt is made to critique the schools of thought or the ideas contained there-

in. We are also well aware of the pitfalls that are to be encountered in trying to describe the essential elements of a particular school of thought when there are continuing, and occasionally acrimonious, disputes within some (and probably all) schools. Our response, in short, is that the benefits of identifying the schools of thought as presented here exceed the costs of expressed misgivings by those few within each school of thought who object to or refuse categorization.

The present significance of the interrelations between law and economics is evidenced by a variety of indicators. First, there is the relatively recent establishment of the American Law and Economics Association, the Canadian Law and Economics Association, and the European Association of Law and Economics. Second, there are now a number of leading publications dedicated to publishing the scholarly contributions to this field, including journals such as the *Journal of Law and Economics*; the *Journal of Legal Studies*; the *Journal of Law, Economics & Organization*; *Public Choice*; *Constitutional Political Economy*; the *International Review of Law and Economics*; and the *European Journal of Law and Economics*. In addition, there are a wide variety of traditional law reviews that now regularly publish Law and Economics articles, and three research annuals—the *Supreme Court Economic Review*, *Research in Law and Economics*, and *The Economics of Legal Relationships*—devoted to Law and Economics. The extent and significance of this literature is reflected in the fact that in 1991 the *Journal of Economic Literature* formally recognized Law and Economics as a separate field within its classification system of the discipline of economics. A third indicator is the existence of a number of programs in law and economics within the major law schools, including Harvard University, Yale University, Columbia University, Stanford University, and the University of California–Berkeley, and the very active working paper series associated with these programs. And finally for the past twenty-three years Henry G. Manne, Dean of the George Mason University School of Law, has organized and hosted the Law and Economics Institutes for Law Professors and for Economists (now held each summer at Dartmouth College); together these two institutes have had over one thousand professors of economics and law as well as judges attend their programs.[3]

THE PRESENT SITUATION IN LEGAL-ECONOMIC SCHOLARSHIP

Although the seeds of contemporary Law and Economics go back at least a century,[4] it has been in the last four decades that it has emerged as a substantial and important body of thought within both economics and law. During this time, Law and Economics has developed within (and in part because of) a somewhat uncertain and unsettled jurisprudence—what may be termed the ambiguous milieu of law. What once existed as prevailing legal doctrine de-

rived from conventional political and legal theory still exists, but law no longer develops in a self-contained, autonomous manner. It has been observed that "[l]aw is now recognized by most teachers of law to be a multidimensional phenomena—historical, philosophic, psychological, social, political, economic and religious" (Packer and Erlich, 1973, p. 56). In addition, commentators such as Lewis Kornhauser (1984, p. 361) have suggested that almost all American legal scholars, judges, and lawyers hold an instrumental view of the law—instrumental in the sense that legal rules are adopted so as to promote some goal, be it equality, justice, fairness, or efficiency.[5]

The study of law is now joined by the ideas and doctrines comprising the several schools of thought that we include under the heading of Law and Economics, as well as by the work of the rights-based theorists,[6] feminist jurisprudential scholars, and critical race theorists, all of whom claim to have something worthwhile to say as to the emergence and development of the law. The outward turn of law thus far has shown no consensus-type movement toward a new and stable foundation for the law (Minow, 1987). We now stand at a point where legal study constitutes a plethora of competing and often mutually exclusive points of view. To use Alan Hunt's (1987, p. 7) metaphor, the glacier that is law has fractured into numerous pieces, and its replacement (if there is to be one) remains to be determined. Perhaps the present situation of the law was best summed up in the comment that "[w]ith the demise of Realism, legal scholarship was left with a plethora of explanatory frameworks, [and] a dearth of criteria for choice among them" (Note, 1982, p. 1676).

The present situation in law and its relationship to economics did not arise in a vacuum. Rather, it is partially the outcome of the development of the *Law* of Law and Economics—in particular, the various evolving perspectives from which one can and should analyze the prevailing *legal relations governing society*—and the development of the *Economics* in Law and Economics—particularly as embodied in the work of neoclassical microeconomists since Alfred Marshall. In the next section, we will examine briefly the path that has led law to its present situation. This will be followed by a brief characterization of the relevant concepts of economic efficiency variously employed by legal-economic scholars.[7] Finally, we will present a description of the underlying logic of Law and Economics.

THE *LAW* IN LAW AND ECONOMICS

The Nature of Common Law

Common law, as it has developed from the English royal courts of centuries past to present-day America, can be said to consist of principles developed gradually by judges as the foundation of their decisions. The history of this common law jurisprudence has at its foundation a search for moorings, for

a set of interpretive and adjudicatory principles from which to justify judicial decisions, guide the law's development, and ground its legitimacy and authority. During the Middle Ages, the interpretation of law was profoundly influenced by theological considerations, as law claimed to stand as divine revelation or the will of God. From the time of the Renaissance until the middle of the nineteenth century, this idea received a somewhat more secular cast, as law was said to be grounded in ultimate principles or ideas, such as natural law. Against this metaphysical approach came the positivist scientific attitude toward the law, an attitude born out of the success of the natural sciences in the nineteenth century and the attempts by the social sciences, as well as the law, to apply the methods of the natural sciences.[8] The constant here is that judges of various jurisdictions (from England to America) have added to, and continue to recognize, the authority of this accumulating body of common law.

Sir William Blackstone suggested that the common law can be interpreted as a mass of custom and tradition, manifested in *judge-made maxims*.[9] These so-called maxims of the common law symbolized the broad guidelines which could be considered to underlie and direct legal decision making. As observed by one commentator, "these maxims were the essential core of the common law, woven so closely into the fabric of English life that they could never be ignored with impunity" (Sommerville, 1986, p. 96). This concept of "maxims" points to the enduring idea that the heart of the common law is not comprised of specific decisions as to rules, doctrines, or procedures, but rather of broad notions which are difficult to systematize but nonetheless remain, in some way, woven into the fabric of life. Whereas some commentators observed a surface chaos in these accumulated judicial decisions, classical common law thought continued to argue that it remained an internally coherent, unified body of principles—principles that comprised the substrate of common law. The emphasis on the more malleable principles, as opposed to the less flexible "doctrines" or "rules" of common law, was intended to convey the notion that the common law remained flexible, that is, that the law retained a dynamic character needed in legal decision making in modern society. Indeed, within the United States, at least, the period between the Revolutionary and Civil Wars witnessed a movement "'to frame general doctrines based on a self-conscious consideration of social and economic policies'" that would meet the needs of the time (Duxbury, 1995, p. 9, quoting Horwitz, 1977, p. 2).

Doctrinalism

The second half of the nineteenth century witnessed a positive, scientific movement across many intellectual disciplines, wherein these various disciplines attempted to apply formalistic principles that would give them the status

accorded to the natural sciences. The legal manifestation of this more general movement was doctrinalism, which is concerned with the law as it is, apart from reference to the religious, metaphysical, or socioeconomic principles of earlier eras. Law here is not a search for the principles of some natural or divine law, but rather a scientific enterprise which "takes as its starting point a given legal order and distills from it by a predominately inductive method certain fundamental notions, concepts, and distinctions" (Bodenheimer, 1974, p. 95). It is, as Julius Stone (1950, p. 31) has said, primarily concerned with "an analysis of legal terms, and an inquiry into the *logical* interrelations of legal propositions."

It was Christopher Columbus Langdell, Dean of the Harvard Law School, who perhaps came to be most closely associated with this view in American law.[10] Langdell both established the case method within American legal education and promoted the use of this method as necessary for teaching law as a science. He saw law as a set of principles or doctrines that were imbedded in legal cases and revealed through the study of cases over time. Given this, he considered the judicial opinion to occupy a place of preeminence in law, as the corpus of judicial opinions embodied "a handful of permanent, unchanging, and indispensable principles of law" (Posner, 1990, p. 15) that revealed themselves in different guises in different cases. These doctrines, he believed, could only be mastered through the careful and exacting study of cases, and the task of legal reasoning thus became that of discerning the doctrines from the opinions. Because of his emphasis on the evolution of legal doctrine from opinions, Langdell had little use for those areas of law that arose from other sources, such as statutes and the Constitution.

Langdell, says Lawrence M. Friedman (1973, p. 535), believed that law was "a pure, independent science" whose data consisted solely of legal cases. From this body of knowledge it was possible to decide individual cases through the use of syllogistic reasoning from the precedential principles set forth in previous like cases. Inherent within this perspective is the idea that judges neither make nor create law; they interpret and apply it (Cotterrell, 1989, pp. 21–37). In deciding cases, the judge expresses part of the total, immanent wisdom of the law (a wisdom existing only in one's mind) which is assumed to be already existent before the judge's decision. The judge works from within the law and thus from within the repository of the experience of the community over time—a community imbued with its own culture and customs. It is the judge's discernment of the community's culture and customs over time that lends both authority and legitimacy to the common law. Inasmuch as the common law is seen to be residing in the community and not the political arena, the emergent legal order comes to command the highest respect. If instead the judge had *made* the law—that is, had imposed the law on the community as if he were a political ruler or the servant of one—his authority would be undermined. Inasmuch as a judge's authority is based on his being a representative of the com-

munity, he is thereby able to *state* the community's law—not *make* the community's law (Cotterrell, 1989, p. 27).

Perhaps nowhere is doctrinalist ethos better characterized than by William W. Fisher, Morton J. Horwitz, and Thomas A. Reed (1993, p. vii), who, in the introduction to their book *American Legal Realism*, say that

> Properly organized, law was like geometry. . . . Each doctrinal field revolved around a few fundamental axioms, derived primarily from empirical observation of how courts had in the past responded to particular sorts of problems. From those axioms, one could and should deduce—through noncontroversial, rationally compelling reasoning processes—a large number of specific rules or corollaries. The legal system of the United States . . . did not yet fully conform to this ideal; much of the scholars' energies were devoted to identifying and urging the repudiation of rules or decisions that disturbed the conceptual order of their respective fields. But once purified of such anomalies and errors, the scholars contended, the law would be "complete" (capable of providing a single right answer to every dispute) and elegant.

This doctrinal method served to legitimate judicial decisions through the logical power of the inductive process and the weight of jurisprudential history. In the process, says Friedman (1973, p. 535),

> the new method severed the cords, already tenuous, that tied the study of law to the main body of American scholarship and American life. Langdell purged from the curriculum whatever touched directly on economic and political questions, whatever was argued, voted on, fought over. He brought into the classroom a worship of common law and of the best common-law judges. Legislation he disdained; illogical decisions he despised. All this he cloaked with the mantle of science. He equated law absolutely with judges' law; and judges' law was narrowed to formalism and abstraction.

Law, under this approach, was self-referential, consisting of a set of objectively inferable rules and procedures logically applied. Law thus became both formal and insular. Jurisprudence consisted only in an established body of legal doctrine, a set of principles in which judicial discretion was minimized, and where ethics, social conditions, politics, ideologies, and the insights of disciplines outside of the law had no proper place.

Friedman (1973, p. 536) suggests that the attraction of Langdell's method was that it served the needs of the profession at that time: "It exalted the prestige of law and legal learning; at the same time it affirmed that legal science stood apart, as an independent entity, distinct from politics, legislation, and the man on the street." The professional belief in the lawyer's monopoly of legal practice was reaffirmed by law's status as a profession that required a rigorous, formal education. The bar association movement, which entrenched the professionalization of the law, arose at the same time as Langdell's move-

ment, and the two fed off each other. Whole subject areas in the present law school curriculum—for example, contracts, torts, and property—have had their boundaries fixed and are distinguished from each other by their respective common law principles. Indeed, today, much of legal education and legal scholarship consists of the exposition and systematization of these general principles and the techniques required to discern and apply them, together with the legal rules, doctrines, and procedures that emanate therefrom.

Moving Away from Doctrinalism

Reaction against doctrinalism gained influence in law already in the late nineteenth century. The early scholarship in this area, which might be classified as "sociological jurisprudence," was contributed by such notable expositors as Oliver Wendell Holmes Jr., Roscoe Pound, and Benjamin Cardozo. Sociological jurisprudence was a reaction against both the formalism of doctrinalism and the traditional concepts of natural or objectively determinable rights.[11] These writers claimed that law cannot be understood without reference to social conditions, and against the idea of the autonomy of law was posited the idea that insights from the other social sciences should be integrated into the law. Judges, they said, should be aware of the social and economic conditions which affect the path of law and which result from the legal decision-making process (Bodenheimer, 1974, pp. 120–21).

Cardozo emphasized the need for judges to be attuned to social realities and, while not rejecting the role of analytic processes in jurisprudence, believed that "considerations of social policy loom large in the art of adjudication" (Bodenheimer, 1974, p. 121). Both judicial decision making and the path of law, he said, are necessarily influenced by subjective elements of instinct, belief, convictions, and views as to social need. Although precedent was important for Cardozo, he believed that when it conflicted with the greater interests of justice or social welfare, the latter should carry the day (Bodenheimer, 1974, p. 121).[12]

Holmes (1923, p. 1), like Cardozo, emphasized the limits of doctrinalism, but went further than Cardozo in discounting the role played by logical reasoning in jurisprudence: "The felt necessities of the time, the prevalent moral and political theories, intuitions of public policy, avowed or unconscious, even the prejudices which judges share with their fellow men, have a good deal more to do than the syllogism in determining the rules by which men should be governed." Law, in his view, expresses the will of the dominant interests in society. Holmes, says Richard A. Posner (1987a, p. 762), "pointed out that law is a tool for achieving social ends, so that to understand law requires an understanding of social conditions"; in addition, Holmes held that judges need to be acquainted with the historical, social, and economic aspects of the law (Boden-

heimer, 1974, p. 123).[13] These ideas were echoed by Pound (1954, p. 47), who saw law as "a social institution to satisfy wants" and the history of law as "a continually more efficacious social engineering." These pragmatic and socially attuned conceptions of law set the stage for an even more pronounced move away from the past—Legal Realism.

The Legal Realist Challenge

The most influential of the challenges to doctrinalism was the Legal Realist movement, which reached its zenith in the 1930s. The Realist movement was part of a more general response to formalism and logical reasoning in the early twentieth century, wherein American intellectual life was impacted by "a more empirical, experimental, and relativistic attitude toward the problems and guiding assumptions" of the various scholarly disciplines (Purcell, 1988, p. 359). The Realists, following the work of Holmes, sought to turn law outward to make it attuned to the social realities of the day. In the process, they affected both the process of legal education and the intellectual life of the law (Friedman, 1973, p. 591).[14]

The reverence for the traditions of the law, so central within doctrinalism, held little sway among the Realists. The divergence between the law as written into books as compared with the law as it operates in fact was relentlessly pursued. The Realists rejected the existence of objectively determinable rights; the use of rigid legal rules, categories, and classifications; appeals to the authority of the past—citations, eminent jurists, and classic treatises; and the logic of reasoning from precedent. The Langdellian system in general was thus anathema to the Realists. Karl Llewellyn (1934, p. 7), a leading Legal Realist, suggested that the role of legal rules within the lawmaking process was far less important than generally assumed, and that "[t]he theory that rules decide cases seems for a century to have fooled, not only library-ridden recluses, but judges." In a similar vein, Jerome Frank asserted that, contrary to the logical cloak in which they are enveloped, judicial decisions are largely informed by "emotions, intuitive hunches, prejudices, tempers, and other irrational factors" (Bodenheimer, 1974, p. 125). The judge, rather than the logic of the law, was the central factor in the resolution of legal cases. Law was seen not as a set of rules, but as what judges actually do.[15] The logic of precedent, according to the Realists, was seriously flawed. The use of precedential reasoning was essentially the determination as to whether the decision in an earlier case could be applied in straightforward fashion to the facts of the case at hand. The human factor underlying this form of judicial decision making was apparent to the Realists: Such decisions inevitably entailed a choice as to the relation between the facts of one case and another, a choice that was necessarily determined by subjective value judgments rather than by logic (Mensch, 1990, p. 22). Because decisions rested on the judge's conception of right and wrong, social,

political, and economic considerations became important variables. Furthermore, the constant change of law (perhaps most strikingly in response to the industrial revolution) belied the claim that law was certain, fixed, and logical. Against the formalist view of law as a deductive science, then, came the Realist emphasis on developing legal theory through inductive scientific principles (Duxbury, 1995, p. 80).

Along with the idea that law cannot be a logical, self-contained discipline came the prescription that it should cease all pretensions of being so, and that law should become more overtly attuned to the social ends that it necessarily serves. The Realists held a strong instrumentalist conception of law: For them, law was, and had to be seen as, a "working tool" (Friedman, 1973, p. 592). This demanded an understanding of the relationship between law and society and of the way that results—economic, political, and social—followed upon legal decisions. Every legal decision was understood to have social, ethical, political, and economic implications, and the Realists maintained that these should be recognized and explicitly dealt with by judges, not hidden behind a veil of logical reasoning. Thus, the Realists contended that to better understand these implications, it is necessary to explore the interrelations between law and the other social sciences, including sociology, psychology, political science, and economics.

Of particular import for present purposes is the Realist interest in using economics to understand and to guide the development of law.[16] The Realists argued that the importance of the interrelations between law and economics can be seen in the twin facts that legal change is often a function of economic ideas and conditions, which necessitate and/or generate demands for legal change, and that economic change is often governed by legal change.[17] Karl Llewellyn pointed to a number of ways in which law influences economic conditions, including its role in providing a foundation for the economic order, its influence on the operation and outcomes of the competitive market process (particularly through the structure of law pertaining to property, contract, and credit, and through restrictions placed by law on the competitive process), and the influence of taxation, social welfare legislation, and public enterprise on production and distribution.[18]

Given the important interdependencies that they saw between law and economy, it is not surprising that Realists such as Llewellyn considered economic analysis a useful tool for understanding law and legal change and for devising laws that would improve the social condition. Indeed, Samuel Herman went so far as to assert that "[t]he law of a state never rises higher than its economics" (Herman, 1937, p. 831), and expressed the hope that "'a disciplined judicial economics' might become 'a realistic and tempered instrument for solving the major judicial questions of our time'" (Samuels, 1995, p. 263, quoting Herman, 1937, p. 821). And whereas the Realists found certain aspects of neoclassical economics, such as marginal analysis, useful, it was with the institutional economics of Thorstein Veblen and John R. Commons, rather than