THE CONOMIC OF THE LAW

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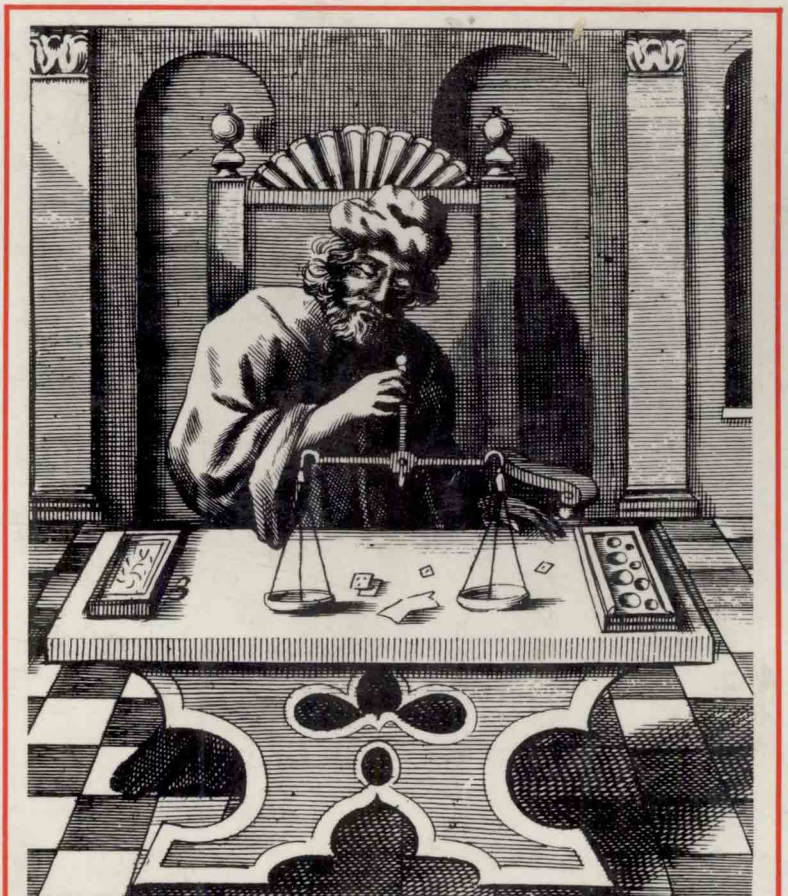

The Economics of the Law

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Preface

The writing of this book would not have taken place without the support and encouragement of a number of people. Most important are the contributors to the growing law-and-economics literature without whom there would be little to write. My interest in the use of economic reasoning in the area of the law was nurtured during many commuting journeys with Eric Young.

I could not have immersed myself so freely in this literature without the benefit of a sabbatical term spend at the Faculty of Law at the University of Toronto. This was made possible by the generosity of the University of Strathclyde in granting me leave, the British Academy for its financial support, and the Connaught Fund grant to the Faculty of Law in Toronto. I also benefited from visits to Yale, Chicago and Northwestern Universities and the Law Institute for Economics Professors held at Dartmouth College, New Hampshire under the auspices of Henry Manne. During this period I benefited from discussions with a number of people including Guido Calabresi, Bob Ellickson, Richard Epstein, Victor Goldberg, Henry Hansmann, Bill Landes, Anthony Ogus, George Priest, Rob Prichard, Steven Shavell, Michael Trebilcock, Oliver Williamson and Arnie Weinberg. I am grateful to the Carnegie Fund for the Universities of Scotland whose financial assistance made these visits possible.

I am also most grateful to the members of the Law School at the University of Strathclyde who have answered my many questions concerning law. Particular thanks are due to Eric Young who not only encouraged my interest in the subject but

read the first draft of this material in its entirety. Anthony Ogus was kind enough to read all of the text. Any remaining errors are decidedly my own.

The typescript was prepared with skill and great fortitude by Irene Nugent and Morag Pryce. I am most grateful to my wife Christine and my daughters Kate and Lucy who have put up with much in the book's preparation and to whom it is dedicated.

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PART II LAW

1 Introduction

In the last two decades or so the academic study of law, particularly in North America, has witnessed an increased use of economic concepts and modes of reasoning. This book is an attempt to synthesise this growing literature in a way which makes it accessible to students and academics in both disciplines without overselling the significance of the economic approach to the law. The reader should be clear from the outset what this book is *not* about. It is not about the traditional interactions of the two subjects, e.g. anti-trust or competition law: these are concerned with the regulation, by statute or courts, of economic behaviour. Nor is it about the economic evaluation of particular items of legislation: cost-benefit analysis or impact analysis. It is about the application of economic modes of analysis to legal rules and doctrines. Given the assumptions about human behaviour and motivation commonly made by economists, what are the implications for legal rules and doctrines? What are the implications of economic concepts such as 'efficiency' for the design of legal rules. The literature which embodies these concerns has come to be designated 'law-and-economics' to distinguish it from other areas of intersection of the two disciplines. Viewed by the legal scholar, this book is a somewhat narrow approach to jurisprudence. Viewed by the economist, it is the application of the tools of his trade to a specific area of social activity.

Law-and-economics is now an integral part of legal education in many of the most distinguished law schools in North America, both as a course in its own right and as a

component of courses in torts, contracts and property. It has been argued that it is no longer possible to be a 'serious theorist in tort law or contract law without at least being familiar with, and taking account of, the economic analysis in these fields' (Hansmann, 1983). The subject however, has not had the same impact on the eastern shores of the Atlantic.

What economics is providing here is a theoretical framework for analysing the law: a means of deriving predictions about behaviour given 'the law' or a means of deriving a set of rules to produce desired behaviour. This is a very different approach from that of traditional legal scholarship. Much of that scholarship is devoted to interpreting cases. It is an *inductive* process in which the cases are examined to see what categories emerge. In contrast, the economic approach is *deductive*. Assumptions are made about human behaviour and the implications of these for specific circumstances are deduced. This 'model-building' approach may perceive (or indeed seek out) categories implicit in the cases. As later chapters of this book will demonstrate, whilst legal doctrine treats nuisance, torts and contract as separate compartments, law-and-economics focuses on very definite similarities among the problems dealt with in these doctrines.

The terms normative, positive and descriptive law-and-economics have been imported from economic methodology to categorise different applications of economics to the law (see Burrows and Veljanovski, 1981; Veljanovski, 1982). Normative theories are those which embody value-judgements and imply an exhortation, e.g. 'The government *should* ensure all markets are competitive'. This statement embodies the value-judgement that competition is a desirable objective of public policy. As such it is not a matter of fact but a belief. On the other hand, a positive statement is a question of fact and can therefore, in principle, be subjected to scientific test, e.g. 'the sun will rise tomorrow' is a refutable or testable hypothesis. Provided observers agree on the meaning of the words used, we only have to observe what happens tomorrow to test the hypothesis. Descriptive economics, according to Veljanovski (1982), attempts to model actual processes and to describe the economic influences that affect them. The normative/positive distinction has come in for increasing

criticism as economists have become more sophisticated in their appreciation of methodology.

Much of what is described as positive economics in textbooks is really *prescriptive* (Machlup, 1969). It prescribes the behaviour (or rules) necessary to obtain a stated goal without necessarily suggesting that the goal should be an object of public policy. Consider the statement that to maximise profits firms should equate marginal revenue and marginal cost. This neither says that firms actually equate marginal revenue and marginal cost (therefore it is not positive) nor that firms ought to equate them, nor that they ought to maximise profits (thus it is not normative). The statement is prescriptive: if profit-maximisation is desired, marginal revenue and marginal cost must be equated. The proposition may also be described as analytical (see McLachlan and Swales, 1982). Most of the law-and-economics in this book is analytical/prescriptive in this sense in that it analyses the efficiency implications of different legal doctrines without arguing that efficiency should be the touchstone of legal doctrines. In the final chapter of this book some normative propositions will be addressed.

The term positive law-and-economics is usually used to describe two somewhat different approaches: one concerned with *prediction* and one with *description*. A number of economists following the lead given by Milton Friedman take the view that one of the roles of economic theory is to allow us to predict human behaviour. Consequently the validity of a theory is to be judged by the correspondence of its predictions to the 'facts'. Thus, whether or not a theory's assumptions are realistic or descriptively accurate is irrelevant so long as the theory is predictively accurate. Although for a number of years this approach was labelled 'positivist', in recent years academics concerned with economic methodology have come to recognise that it is more correctly described as 'instrumentalist' (see Caldwell, 1983).

The predictive (or instrumentalist) approach has been used very successfully in one area of intersection between law and economics: the economics of crime. Here models of individual and household behaviour have been used to develop predictions about the response of criminals or potential criminals

to different detection and sentencing policies (Becker and Landes, 1974; Heineke, 1978; Wolpin, 1978). This, however, is not law-and-economics as we have defined it. It is really straightforward economics and has had little impact on legal scholars. We therefore, do not discuss that literature in this book.

The second sub-category associated with the term positive law-and-economics is what Burrows and Veljanovski (1982) call descriptive law and economics. This has had a greater impact on legal scholars. Here 'the structure of the legal system itself' is the focus of analysis. As these authors point out, the weakness of assumptions is much more important here because such theories require to have substantive descriptive content and the assumptions themselves require to be verifiable. (For a discussion of the role of assumptions and the relevance of their realism, see Caldwell, 1983.)

The early thrust of 'descriptive' law-and-economics arose from the work of R.A. Posner, Professor of Law in the Chicago Law School. (At the time of writing Professor Posner is a Justice of the US 7th Circuit Court of Appeals.) Starting in Posner (1972b), he argued that the implicit goal of the common law was the promotion of an efficient allocation of resources. The doctrines, remedies and procedures of the common law are seen to be consistent with the pursuit of efficiency. This work stimulated both emulation and criticism: whole issues of North American law journals were devoted to its discussion. The problems associated with evaluating this claim are discussed in the final chapter of this book. For the moment it is sufficient to say that the claim is more sceptically received now than it once was. A more modest formulation of Posner's descriptive claim has been suggested by Professor Frank Michelman of Harvard Law School: 'that the rules, taken as a whole, tend to look as though they were chosen, with a view to maximizing social wealth (economic output as measures by price) by judges subscribing to a certain set of ('micro-economic') theoretical principles' (Michelman, 1979).

This formulation suggests that judges do not consciously maximise social wealth but that they behave *as if* they did. This is more in line with the instrumentalist approach rather than the descriptive approach. For an example of an empirical

study in the spirit of Michelman's statement, see Stephen and Young (1985). The descriptive claim amounts, in effect, to saying that a set of legal rules or judicial decisions can be rationalised (i.e. made consistent) by imputing an economic (or economist's) rationale to it. This does, of course, raise the common problem of inductive reasoning: that there may be many rationales consistent with a given set of events or 'facts'.

The use of economics to provide the rationale underlying legal rules and judicial decisions has been suggested in a slightly different way by another legal scholar. L.A. Kornhauser (1980) suggests that economics might be seen as a source of 'behavioural hypotheses' or 'insights' in to the study of the law. Indeed, much of the scholarship discussed in this book can be seen in this light: models of human behaviour commonly adopted in economics are used to try to provide a better understanding of the law and its consequences.

What Michelman and Kornhauser (and many others) are pointing to is the differences between the methodology of the traditional legal scholar and the traditional economics scholar. It is the latter which provides the methodology of law-and-economics. Much traditional legal scholarship is devoted to interpreting cases: an inductive approach in which cases are examined to see what categories emerge. The economist's approach, on the other hand, is deductive: assumptions and the implications of these assumptions for behaviour under specific conditions or circumstances are deduced. This approach has (somewhat grandiosely) come to be described as 'model-building'. It is an approach which may perceive (or indeed seek out) categories implicit in the cases. What it provides is a free-standing framework for analysis which is independent of the particular materials being investigated: a general theory. (For more on these points, see Coase, 1977; Klevorick, 1983.)

The preceding discussion may give the impression that legal scholarship has a great deal to gain from economics whilst there is little to be gained by economists from legal scholarship. This is not so. Yet there is a danger that law-and-economics may be seen as a colonisation of legal scholarship by economists: a part of a wider imperialism through which economics has expanded its boundaries into terrain previously inhabited by other social science disciplines. Ronald Coase

(1977) has argued that such a movement cannot be based solely on techniques since the techniques of economics will be quickly learned by the other social scientists who will have the advantage of being more familiar with, and sensitive to, the terrain in which the techniques are to be applied. To some extent what has happened in law-and-economics bears this out. Many legal scholars have been quick to absorb the techniques and method of economics which they are able to use to great effect in the area of law in which they have a comparative advantage over economists. However, some of the early work in this field exhibited the over-enthusiasm and lack of subtlety of both the recent convert and the campaigning missionary.

But Coase (1977) made another point: economics has much to gain from forays into foreign terrain because they will make economists aware of the effect that other dimensions of the social system have on the functioning of the economic system. In particular, economists who have worked beyond the traditional boundaries of their subject have to become particularly aware of the important effect that social institutions have on human behaviour. The law is an important and pervasive social institution. An area where economics has benefited from contact with other social sciences is what has come to be known as 'transaction cost economics'. This will be discussed more fully in the latter part of Chapter 8 when we discuss contract. The point of direct relevance here is that law-and-economics is a two-way street: both economists and lawyers can learn a great deal to the benefit of their own scholarship from it. However, both must be sensitive to its limitations. As Michael Trebilcock (1983) has pointed out, the more sophisticated law-and-economics has become the less-clear-cut are its implications for policy.

This book is divided into two parts. Part I deals with economic concepts, whilst Part II analyses legal doctrines and institutions using these economic concepts. This division allows readers familiar with the economic concepts to go straight to their application. All economists will be familiar with the material of Chapter 4. Fewer will, I think, be familiar with Chapters 2 and 3. Whilst the Coase Theorem has had sufficient impact on the mainstream economics literature to be

discussed in intermediate microeconomics textbooks (e.g. Call and Holahan, 1980), as well as the literature on externalities, non-specialists are unlikely to be familiar with all of the subtleties and limitations discussed in Chapter 3. Similarly, general ideas about property rights have permeated the mainstream literature without everyone becoming familiar with the literature discussed in Chapter 2. Non-economists should not find the pace at which the concepts are introduced too quick. In teaching lawyers I have found that absorption of the economic concepts is aided by introducing them in the context of a legal discussion. Consequently, I weave the material of Chapters 2 and 3 into the material of Chapter 5. However, this approach is not so readily transferred to the printed medium. In addition it would make for tedious reading by those competent in economics. If the book is being used as the basis of a course for non-economists I would suggest that the interweaving be undertaken.

Part II does not represent a comprehensive treatment of legal doctrines using economic concepts. Neither space nor competence permits this. Such an approach is provided in Posner (1977). The focus here is on property, tort and contract. However the treatment of these topics is far from exhaustive. Each of them could give rise to a sizeable book, as indeed they have (e.g. Ackerman, 1975; Posner, 1982; and Kronman and Posner, 1979). The approach here is to introduce the subject and give an insight of its usefulness and limitations. Chapter 6 has three main sections dealing with conflicts in the use of property (nuisance), the compulsory acquisition of private property by the State (eminent domain and compulsory purchase), and the public regulation of land use (zoning and development control). Thus both common law and public law doctrines in respect of property are examined using economic concepts introduced in Part I, together with the property rules/liability rules framework discussed in Chapter 5. Chapter 7 turns to tort (or delict as it is called in Scotland), a second pillar of the common law. Here the doctrines of strict liability, negligence, contributory negligence and comparative negligence are examined both in terms of efficiency and from the perspective of distributive justice. The economics of contract law is the subject-matter of Chapter 8.

Here such topics as consumer warranties, standard-form contracts and damage for contract breach are analysed. The transactions cost or neo-institutional approach to contract is introduced here. In the final chapter the claim that the common law is efficient is examined, as well as Posner's claim that value-maximisation is the only ethically justified basis for the common law. The final part of the chapter (and the book) outlines Paul Rubin's evolutionary theory of the common law.

Part I
Economic Concepts