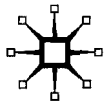
The Pursuit of Justice

Law and Economics of Legal Institutions

Edited By

Edward J. López

Foreword by Robert D. Tollison



Cover image: © Kelly Redinger/Design Pics/Corbis.
Front cover design by Christopher Chambers.

First published in 2010 by
PALGRAVE MACMILLAN®
in the United States—a division of St. Martin's Press LLC,
175 Fifth Avenue, New York, NY 10010.

Where this book is distributed in the UK, Europe and the rest of the world, this is by Palgrave Macmillan, a division of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States, the United Kingdom, Europe and other countries.

ISBN: 978–0–230–10245–3

Library of Congress Cataloging-in-Publication Data is available from the Library of Congress.

A catalogue record of the book is available from the British Library.

Design by Newgen Imaging Systems (P) Ltd., Chennai, India.

First edition: June 2010

10 9 8 7 6 5 4 3 2 1

Printed in the United States of America.

FOREWORD

Robert D. Tollison

Public choice and law and economics were distinct revolutions in economic thought, expanding the economic method of *homo economicus* into areas traditionally reserved for other disciplines. Both developments took place at approximately the same time (the 1950s and 1960s), and many of the same scholars participated in laying the theoretical foundations in both public choice and law and economics. A partial listing in no particular order would include Ronald Coase, James Buchanan, Gordon Tullock, Gary Becker, Richard Posner, George Stigler, Henry Manne, Armen Alchian, Harold Demsetz, and still others. Over time, as these new subdisciplines found acceptance as "normal science," the two areas of research evolved into courses and research programs that were and largely remain independent of one another. Recognizing that I am painting with a broad brush, the law and economics subdiscipline grew into a largely normative enterprise of evaluating legal rules and institutions relative to some normative standard such as economic efficiency. One branch of public choice produced what sometimes seemed like never-ending and highly complicated analyses of voting rules and other political institutions. But a second tradition of positive public choice also emerged, in which economic methods were applied to politics and political decision-making in order to understand how government worked as opposed to how it "ought" to work. In the positive economic approach, government is not decried as being "inefficient" in some sense, but rather is seen as a purposeful enterprise organized, staffed, and run by the children of Adam Smith and Bernard Mandeville.

The maintained hypothesis here is that law and economics shied away from the positive economic analysis of law and its attendant actors and institutions. This is not to say that there have been zero contributions in this vein. The point is simply that there is more than ample room for development here, which brings me to this volume.

Edward López and his co-authors have produced an original book that contributes significantly to the positive economics of law and economics. This to me is a valuable and useful undertaking, and it will hopefully stimulate additional work along these lines. Rather than, for example, looking at law and economics as a critique of legal decision making vis-à-vis an economic efficiency standard, these authors seek to model and explain/predict

judicial behavior with the standard tools of economics and econometrics. Not only do these papers model and derive testable implications in a wide variety of legal settings, they offer tests of the models, often with extensive and unique data sets. Many different legal actors are analyzed—judges, lawyers, regulators, district attorneys, plaintiff attorneys, juries, and so on.

Some of the chapters (chapters 7 and 9) follow the format of critiquing legal decisions and processes from a normative perspective, and this is unobjectionable. The bulk of the chapters, however, are new and interesting studies of legal issues in the tradition of positive economics. Even if one is interested in reform, the law of unintended consequences has a corollary—you cannot fix something if you do not know how it works. The chapters in this volume are ultimately the type of research that will provide key guidance to those who seek to improve our legal system. I say "our" because the chapters are basically about legal processes in the United States with the exception of an interesting historical chapter about the evolution of the British legal system (chapter 2).

The Pursuit of Justice, as the title suggests, will also be of value to reformers because it shows how reform requires a finely tuned awareness of the incentives and constraints that shape our legal institutions. Unfortunately, as this book shows, the U.S. legal system is not immune to the problem of government failure. Moreover, when the legal system fails the result is not just inefficiency but also injustice.

As the original generation of public choice and law and economics scholars fade into the history of economic thought, a new generation steps up to carry on, defend, and extend the hard-earned intellectual gains. That is why reading *The Pursuit of Justice* is such a refreshing intellectual experience. There is still much to do and miles to go, but the work demonstrates conclusively that there is a group of young scholars who are on the case and that there are interesting and engaging issues to examine as far as the eye can see. As my old professor and colleague, James M. Buchanan, always says, you have to keep the counters interesting. *The Pursuit of Justice* passes this test by bringing positive economic methods to bear on issues in law and economics not previously addressed from this perspective.

Acknowledgments

This pursuit has been a rigorous and rewarding experience throughout, and I am grateful to many individuals and institutions who gave me their support. I thank the Earhart Foundation and Liberty Fund, Inc., for generously supporting my efforts in this project in its critical early stages. The Independent Institute provided generous financial and staff support to see this book through to its completion. In particular, I want to thank David J. Theroux, Martin Buerger, Roy M. Carlisle, Gail Saari, and especially Alexander Tabarrok, who read every word and improved every chapter. Many individual and collective thanks are due to authors of each chapter for contributing the substance of the book and for their promptness and patience during various stages of the process. For valuable comments and discussion on various parts of the book, I would like to acknowledge Benjamin Powell, Noel Campbell, Edward Stringham, Joshua Hall, Wayne Leighton, and Daniel Green. I thank Jim Buchanan and Gordon Tullock for inspiration. And most of all I thank Jamie and Lorenzo for keeping me grounded in what is truly important.

Edward J. López
San Jose, California
March 2010

Contents

ILLUSTRATIONS

TABLES

FIGURE

CHAPTER 1

AN INTRODUCTION TO *THE PURSUIT OF JUSTICE*

Edward J. López

> The romance is gone, perhaps never to be regained. The socialist paradise is lost. Politicians and bureaucrats are seen as ordinary persons much like the rest of us, and "politics" is viewed as a set of arrangements, a game if you will, in which many players with quite disparate objectives interact so as to generate a set of outcomes that may not be either internally consistent or efficient by any standards.
>
> James M. Buchanan (1979 [1999], 57)

INTRODUCTION

This book presents new research in the study of legal systems as they perform in practice. All the chapters in this volume recognize that judges, lawyers, juries, police, and forensic and other experts, all respond to incentives. In short, the players of the legal game are "ordinary persons much like the rest of us." Thus if we want to understand why the legal system sometimes fails to perform up to our ideals and expectations we must analyze the incentives available to actors in the legal arena and the institutions that set the "rules of the game." Of course, if we want to reform the legal system, we must change the rules of the game so that the individual incentives of judges, lawyers, juries, and other legal actors motivate them to act in the larger social interest. The eleven chapters that follow apply this framework to wrongful convictions, frivolous lawsuits, government corruption, takings, criminal sentencing, regulation of the legal services market, and many other issues.

The Pursuit of Justice takes its scholarly inspiration from applying to the law the methods of public choice theory, which emerged in the 1960s when scholars like James M. Buchanan, Gordon Tullock, and Mancur Olson applied the tools of economic theory to areas of collective action, namely politics and government. The new economics of collective action posed a challenge to the implicit tendency of mid-century scholars to

assume that government was both willing and able to correct market failures and generate efficient outcomes (i.e., Pareto improvements). To penetrate that black box, public choice scholars developed a framework to study how political institutions create incentives for political actors—voters, interest groups, politicians, and bureaucrats. This scholarship showed that government policies do not generally lead to efficiency improvements of markets, however imperfect the latter may be. Thus, the field of public choice has become well known for the argument that the possibility of government failure must be scrutinized in comparison with market failure. This comparative framework naturally lends itself to the study of legal institutions. *The Pursuit of Justice* applies individual rationality to key decision-makers in the law, just as public choice does to political actors and, in turn, just as economics does to consumers, firms, and entrepreneurs.

The modern law and economics movement also emerged in the 1960s when scholars like Ronald Coase, Richard Posner, and Gordon Tullock began to treat legal rules as having economic causes and consequences. Law and economics showed, for example, that legal sanctions act like implicit prices on people's behavior. Economic models were developed to explain decisions such as whether a plaintiff files a suit, whether a person commits a crime, and whether bargaining between private parties can resolve a dispute better than regulation or litigation. When transaction costs exceed levels that allow such bargaining, the process of governance becomes a collective action problem and public choice theory kicks in. Law without romance predicts that key decision-makers in the law will resolve collective action problems in favor of groups that have lower costs of influencing the legal process. The chapters in this volume lend much evidentiary and argumentative support to this claim.

In summary, what does public choice offer to the economics of legal institutions? First, when the unit of analysis is an agent in the legal system—lawyers, judges, juries, and so on—each is analyzed through its rational choice facets. Incentives matter to key decision-makers in the law. Second, public choice provides a framework for analyzing legal institutions as collective action problems. Third, public choice emphasizes comparative institutional analysis, which lends itself nicely to reform considerations. The public choice revolution brought new analysis to the study of public law, wealth redistribution, and political institutions that control politicians. By comparison, the modern law and economics movement brought new analysis to common law, dispute resolution, and legal institutions that control citizens. In this book, the approach is to maintain the toolkit for analysis while shifting the locus of inquiry: How can the common law be used to redistribute wealth; how effectively do legal institutions control key decision-makers in the law? How do judges respond to the political institutions surrounding their offices? What types of reforms would be potentially beneficial? These are the kinds of questions that are considered in the chapters that follow. To lend specific context to

this new locus of inquiry, I next lay some necessary groundwork and then discuss recent trends in the law. I then preview the contents of *The Pursuit of Justice* in detail.

PUBLIC CHOICE AND LAW AND ECONOMICS: ONE VIEW OF THE CATHEDRAL

> One of the most famous essays in law and economics bears the subtitle, "One View of the Cathedral." The metaphor depicts economic analysis as one view for looking at a large, ancient, complex, beautiful, mysterious, sacred object.
>
> Cooter and Uhlen (2004, 4)

By convention, public choice has been viewed as a school of thought separate from the modern law and economics movement. Partly this is due to academic tradition, which draws boundaries around disciplines by subject matter. Yet these two schools of thought share strong historical, methodological, and ideological foundations. So it can be argued that the two traditions provide a single view of the law. By the economic approach taken in this book, it becomes apparent that public choice and law and economics are not distinct ways of viewing legal institutions but in many respects one and the same.

Mueller's classic textbook *Public Choice II* in the field defines public choice as "the economic study of nonmarket decision-making, or simply the application of economics to political science" (Mueller 1989, 1). This migratory description has gradually lost meaning as public choice got intertwined with disciplines such as philosophy (Pincione and Tesón 2006), history (Hummell 1996), finance (Mulherin 2005), psychology (Caplan 2007, Cowen 2005), development (Boettke et al. 2007), linguistics (Reksulak, Shughart, and Tollison 2004), and other fields. Thus, co-founder James Buchanan recently characterized public choice as an approach to social science rather than a part of economics: "Public choice should be understood as a research program rather than a discipline or even a subdiscipline of economics" (Buchanan 2003, 1). One could apply the argument to other schools of thought that have emerged over the past half century. It is confining to say that public choice is about politics, in a similar sense as saying institutional economics is about organizational structure, or neoclassical economics is about the firm, or behavioral economics is about experiments. Each of these fields can be viewed as broad frameworks for understanding interactions of social systems, including business, law, legislation, and constitutional design. Thus, one can view each of these disciplines as an approach to social science.

As a social science, public choice emphasizes certain principles or tools of analysis. First, people evaluate nonpecuniary costs and benefits in the same way in which they respond to economic profit and loss. In other words, political calculations act as shadow prices on rational (or purposive) behavior. Acting as political pressure groups, business firms, for example, use the market and government systems as complementary means to maximize

profit. Policymakers respond to rent seeking pressure, subject to their own ideologies and a host of political constraints, by redistributing wealth toward groups that most effectively organize their collective members into unified action. Under these conditions, the benefits of policy tend to fall in concentrated areas while the costs are diffused among dispersed interests. This wreaks havoc on viewing politics as noble deliberation and highlights its resemblance to everyday transfers of wealth.

Second, legal rules and policies can be evaluated in terms of their economic and political efficiency. A policy that results in a net loss of wealth in the economy is economically inefficient. In contrast, a policy is politically efficient if it achieves a given transfer of wealth at least cost to the affected parties.[1] Thus, public choice provides a framework for explaining how policies that create net losses for society still get passed. For example, import tariffs and antitrust enforcement can be viewed as alternative instruments for restricting the competition of well-organized business groups. The instrument that imposes less lobbying, enactment, and enforcement costs is politically efficient, even though restricting competition by either means is economically inefficient.

Third, public choice emphasizes institutional structure—rather than, say, policymaker ability or intent—to understand the origins of policies. For example, since the U.S. political system is geographically based on single-representative districts, each legislator has a strong incentive to advance budget items that impart benefits to their home district while imposing the costs on the general tax fund. In this system, logrolling and omnibus bills enable policies that would otherwise fail if voted on individually. The institutional structure, not the bad politician, is the root cause of economically inefficient policies such as pork barrel spending. Thus, in order to achieve fewer bad policies, public choice analysis would suggest institutional change—divorcing representation from geography, for example (Shughart and Tollison 2005).

As suggested by its traditional moniker, law and economics is a dyadic intellectual enterprise. Economic theory provides a framework for analyzing the law, and in turn, the law provides fertile ground for testing and thereby further advances economic theory. The framework provided by economic theory essentially consists of three broad concepts and their application to legal problems.[2] First, law and economics treats subjects of the law as rational agents, which are best illustrated by the following startling example.

> [Suppose you] live in a state where the most severe criminal punishment is life imprisonment. Someone proposes that since armed robbery is a very serious crime, armed robbers should get a life sentence. A constitutional lawyer asks whether that is consistent with the prohibition on cruel and unusual punishment. A legal philosopher asks whether it is just. An economist points out that if the punishments for armed robbery and for armed robbery plus murder are the same, the additional punishment for murder is zero—and asks whether you really want to make it in the interest of robbers to murder their victims. (Friedman 2000, 8)

In approaching criminals as rational agents, law and economics examines crimes by applying cost-benefit analysis to the prospective criminal. If a change of legal rule decreases the marginal cost of murder over armed robbery, we should expect to see more armed robberies escalate to murders. More generally stated, people respond to the law as they respond to other incentives. In other words, legal rules act as shadow prices on rational (or purposive) behavior. This in turn can help support the preference for one rule over another.

Second, economics provides a framework for evaluating the societal impacts of legal rules—that is, economic efficiency. In many ways, the law shapes incentives such that individual decisions promote socially beneficial outcomes. Suppose, for example, you sell your car and accept a personal check as payment, without realizing that the buyer is intentionally defrauding you with a forged check. Suppose further that the buyer immediately disappears after reselling the car, which then changes hands several times. Eventually the police locate the car in the hands of the last owner, who has just purchased the car—*your car!*—from a used dealer nearby. Can you recover the car by suing the last owner? The law says no. In the precedent for such a case, the court reasoned that "while the...rule may seem harsh, it is in line with the purposes of the [law], to promote commerce and business..."[3] The rule supports exchange by promoting within buyers a level of trust that they can acquire good title from reputable sellers. Such a rule helps resources to flow to higher-valued uses, and offers strong incentives for sellers to guard against fraudulent mediums of exchange. Economic efficiency helps understand the basis for and social value of such legal rules.

Third, law and economics also analyzes distributional issues, for example by applying the concept of incidence that is familiar from tax burden analysis. Suppose there is a proposal to shift the punishment of white-collar crime from imprisonment to monetary fines. Furthermore, the proposal recommends spending little on enforcement while imposing severe fines on the convicted offenders. Assume that the decrease in enforcement efforts is matched by a proportionate increase in fines so that the number of crimes remains constant. Enforcement is costly to taxpayers and fines are less costly to them than prison terms, and so under these circumstances, the proposal will be an efficiency improvement. However, fewer criminals will be convicted. Thus, the total punishment costs are redistributed to the fewer individuals who get convicted and away from individuals who escape because of relaxed enforcement.[4] Economic analysis helps clarify such distributional issues in the law as well.[5]

There is little fundamental difference between public choice and the modern law and economics movement in their methodological approach. It seems quite natural, therefore, to assess government versus market failure within the legal system—that is, *legal failure*—as this book aims to do.

Where public choice and law and economics may differ is in the character of reforms they recommend. Both traditions emphasize efficient design of broad institutions and legal rules. But public choice favors constraining

lawmakers to minimize their inefficiency, whereas law and economics implies freeing up markets to maximize their efficiency. For example, public choice suggests fundamental changes to constitutions—that is, rules of the game for policymakers—such as a move from majority rule to supermajority rule for legislative bodies on salient issues (Buchanan 2005). Normative law and economics suggests arranging institutions to minimize transaction costs in markets (Cooter and Uhlen 2004). Due to its broader reform emphasis, applying public choice to the law should help support broad market-based reform. One trend in recent legal reform is a focus on narrow, issue-specific changes such as asbestos at the federal level and venue, joint/several liability, hedonic damages, and other narrow points at the state level.[6] In contrast, recent broad-based legal reform (the Class Action Fairness Act) seems more positioned on public choice theory than on insights from law and economics. This suggests not only a role for public choice in analyzing the law, but also a need for doing so in order to gird future broad-based, efficiency-enhancing reform efforts.

RECENT TRENDS AND REFORMS

Recent trends in the legal system clamor for the kind of scholarly attention that the approach taken here provides. In criminal law, scores of federal judges have been grappling with new federal sentencing guidelines, which, under the January 2005 Supreme Court decision in *U.S. v. Booker,* are deemed advisory rather than mandatory.[7] Meanwhile, federal, state, and local agencies continue to lock horns over medicinal marijuana under the controversial June 2005 *Gonzales v. Reich* decision, which expands commerce clause applicability. In response to *Reich,* California's attorney general issued a statement that "Today's ruling does not overturn California law permitting the use of medical marijuana," and nine other state attorneys general followed suit.[8] These kinds of rulings and similar issues suggest a new federalism in which it is debatable how such intergovernmental tensions will be resolved. In property, the *Kelo v. New London* (June 2005) decision has markedly changed the incentives facing local policymakers; on the one hand, they were initially emboldened to more readily threaten and use eminent domain, but on the other hand, they have been constrained by a wave of new state legislation. In tort, despite the Class Action Fairness Act (CAFA), large settlements and damage awards continue to rally the cries of venue shopping, frivolous claims, and abuse. Meanwhile asbestos, tobacco, health care, and pharmaceuticals remain broad areas of waste through litigation.[9]

Recent reforms of the legal system also invite further study. At the federal level, Congress passed laws limiting the liability of firearm manufacturers and makers of certain pharmaceuticals, and judicial procedures were rewritten to instill greater consistency between state and federal courts in class action lawsuits. At the state level, voters and legislators responding to the *Kelo* backlash have enacted numerous legislative restrictions on eminent domain.[10] These actions and other reforms offer the chance to assess

their effects at a scholarly level and outline the trade-offs associated with future reform.

Through a cascade of ideas put into action, public choice analysis of the law has been successful at promoting efficiency-based reforms: from theoretical to empirical research, to broad dissemination, to policymaker absorption, to reform. The CAFA became law in February 2005. This law alters plaintiffs' and their attorneys' incentives by restricting certain forms of attorney compensation and closing loopholes in interstate diversity rules for determining jurisdiction. As a general rule of thumb, plaintiffs prefer state to federal court because in nearly half the states, judges are elected and thus more sensitive to opportunities to transfer wealth from out-of-state defendants to in-state plaintiffs. Prior to the enactment of CAFA, plaintiffs could easily avoid federal courts, in favor of plaintiff-friendly state courts, by finding a single nondiverse class member, or by limiting the claim amount of one member, and so on. CAFA also installed congressional oversight, requiring the Judicial Conference of the United States to report to the House and Senate Judiciary Committees.

CAFA is a public choice reform. Public choice research illuminated the poor incentive structure that prevailed in the pre-CAFA era. Theoretical work in public choice provided the necessary context for understanding civil law partly as a mechanism for transferring wealth in a manner close, if not identical, to rent seeking in politics (Farmer and Pecorino 1999, Rubin et al. 2001, Osborne 2002). In turn, rigorous empirical evidence demonstrated that real-world patterns in tort awards were consistent with theoretical rent-seeking predictions. For example, states with elected judges featured greater award amounts against out-of-state defendants (Tabarrok and Helland 1999). Other evidence showed that the tort system was being used as a mechanism for social justice, for example, the grant of higher awards to states with greater poverty and racial minorities (Helland and Tabarrok 2003). This type of argument was conveyed to a broader audience in the successful book *The Rule of Lawyers* (Olson 2003), and ultimately through policy papers to the personnel who rewrote the rules of civil procedure and codification of the CAFA reform. Public choice ideas have consequences for the legal system.

PLAN OF THE BOOK

> It seems to be nothing more than simple and obvious wisdom to compare social institutions as they might be expected actually to operate rather than to compare romantic models of how such institutions might be hoped to operate.
>
> Buchanan (1979 [1999], 47)

Observing how the law evolves is a useful method for investigating which interests can effectively influence the law in their favor. Beginning with chapter 2 by economists Nicholas Curott and Edward Stringham, for example, we see legal institutions evolving as a result of fiscal expedience to kings.

Curott and Stringham present an economic history of the gradual centralization of English law. Starting from its pre-Norman origins, the law was polycentric and customary with voluntary participation enforced largely by the threat of outlawry made credible by social norms. Incrementally, the law was centralized over time into coerced statutory law. The motivations were largely fiscal demands of kings. Curott and Stringham are thus in the tradition of Bruce Benson (1990) and other economic histories of the rule of law.[11] Chapter 2 provides a new contribution in further informing these ideas with an extensive analysis of noneconomic histories that point generally to the same interpretations. One implication of this body of work involves the viability of voluntary institutions to enforce contract and property—essentially private law—an issue that has received sustained scholarly treatment for decades (e.g., Greif 2008, Dixit 2004, Ellickson 1991, Ostrom 1990, Benson 1990). A common presumption among many theorists is that the formation of a state generates public benefits—a "commodious" life—that would not otherwise be attained. As the body of private law scholarship continues to grow, the effect may be to broaden scholarly views on the relevant trade-offs in analyzing the law of the state. The law of the Hobbesian jungle may not be the singular, necessary alternative. Rather, it is an empirical question whether and in which circumstances law is a pure public good, versus circumstances when private, voluntary enforcement can produce cooperation in basic modes of social interaction.

To be sure, efficiency is but one of several criteria on which to judge the law. In fact, many areas of the law are non-efficient by design. For example, the high burden of proof in criminal procedure is for reasons of justice intentionally biased in favor of protecting the rights of the accused. Traditional purposes for doing so are (a) to protect citizens from the potential of overzealous prosecutors; (b) to counter the imbalance of resources that usually exists between prosecutors and defendants; and, most importantly, (c) to be more hawkish about wrongful convictions (Type II errors) than wrongful acquittals (Type I error).[12] The law intentionally elevates these other values—especially the avoidance of wrongful convictions—above the value of efficiency. However, certain aspects of legal institutions can give decision-makers bad incentives—self-interested reasons to distort the social ordering of values and instead create biases that generate bad outcomes, such as *more* wrongful convictions. Chapters 3 and 4 address these points and similar issues.

In chapter 3, economists Russell Sobel, Joshua Hall, and Matt Ryan scrutinize the effects of different types of selection methods for prosecutors and judges. Across the American states, three different selection methods are used: appointment by governor and/or legislature (29 states); nonpartisan elections (13 states); and partisan elections (8 states). The authors present survey-based data on the perceived quality of each state's overall legal system and estimate the influence of selection type on quality (controlling for populace education, judges' salaries, lawyers per capita, and voter ideology). They find that states with elected judges fare systematically worse on the quality survey, and that almost all of this effect is driven by partisan election states.