

ECONOMIC ANALYSIS OF LAW

POSNER

ECONOMIC ANALYSIS OF LAW

THIRD EDITION

RICHARD A. POSNER

*Judge, U.S. Court of Appeals for the Seventh
Circuit; Senior Lecturer, University of Chicago
Law School*



LITTLE, BROWN AND COMPANY

BOSTON AND TORONTO

Copyright © 1986 by Richard A. Posner

All rights reserved. No part of this book may be reproduced in any form or by any electronic or mechanical means including information storage and retrieval systems without permission in writing from the publisher, except by a reviewer who may quote brief passages in a review.

Library of Congress catalog card no. 85-80152

ISBN 0-316-71438-0

Third Printing

MV

*Published simultaneously in Canada by Little, Brown & Company
(Canada) Limited*

Printed in the United States of America

ECONOMIC ANALYSIS OF LAW

EDITORIAL ADVISORY BOARD

Little, Brown and Company
Law Book Division

A. James Casner, Chairman
Austin Wakeman Scott Professor of Law, Emeritus
Harvard University

Francis A. Allen
Edson R. Sunderland Professor of Law
University of Michigan

Clark Byse
Byrne Professor of Administrative Law, Emeritus
Harvard University

Thomas Ehrlich
Provost and Professor of Law
University of Pennsylvania

Richard A. Epstein
James Parker Hall Professor of Law
University of Chicago

E. Allan Farnsworth
Alfred McCormack Professor of Law
Columbia University

Geoffrey C. Hazard, Jr.
Nathan Baker Professor of Law
Yale University

Bernard Wolfman
Fessenden Professor of Law
Harvard University

PREFACE

Perhaps the most important development in legal thought in the last quarter century has been the application of economics to an ever-increasing range of legal fields, including those at once so fundamental and apparently noneconomic as torts, criminal law, family law, procedure, and constitutional law. Beset as it has been by controversy wholly expectable concerning a movement that challenges not only the methodological but also the political predispositions of many traditional legal scholars as well as many law students, lawyers, and judges — derided as it has often been both as obvious and as obviously wrong — the economic analysis of law has nevertheless managed to attract steadily growing interest, both academic and practical, and to generate an expanding and improving literature.¹

When the first edition of this book was published in 1973, there was neither textbook nor treatise on the application of economics to law. This book was, and is, both. Although still the only treatise, it is no longer the only textbook. There are now on the market a number of edited books of readings, mainly by lawyers, designed particularly for students;² two textbooks by economists;³ and a law-and-economics casebook, also by an economist.⁴ None of these books, however, attempts the breadth and depth of coverage of this one.

The basic choice in doing a textbook about the economics of law is structural: whether to use economic principles or legal principles to organize the book. If economic principles are used, legal principles are then appended as examples. Such an approach, whatever its other

1. For recent, though already somewhat outdated, surveys of the field, see C.G. Veljanovski, *The New Law-and-Economics: A Research Review* (1982); *The Place of Economics in Legal Education*, 33 *J. Leg. Educ.* 183 (1983).

2. See, e.g., *Economic Foundations of Property Law* (Bruce A. Ackerman, ed. 1975); *The Economics of Contract Law* (Anthony T. Kronman & Richard A. Posner, eds. 1979); *Economics of Corporation Law and Securities Regulation* (Richard A. Posner & Kenneth E. Scott, eds. 1980); *Readings in the Economics of Law and Regulation* (A.I. Ogus & C.G. Veljanovski, eds. 1984).

3. Werner Z. Hirsch, *Law and Economics: An Introductory Analysis* (1979); A. Mitchell Polinsky, *An Introduction to Law and Economics* (1983).

4. Charles J. Goetz, *Cases and Materials on Law and Economics* (1984).

merits, cannot convey an adequate sense of the integrated structure of legal principles and institutions. The law is a system; it has a unity that economic analysis can illuminate; but to see the unity you must study the system. This book tries to make the economic principles emerge from a systematic (although necessarily incomplete) survey of legal principles. A glance at the index will show that most topics in microeconomics (price theory)⁵ are discussed in the book, although not in the same order as in an economics textbook. Since so much of the legal system is concerned with nonmarket behavior — with the family, crime, accidents, litigation, and much else that is remote from the conventional marketplace of economic theory — this book emphasizes the economics of nonmarket behavior more than is customary in a microeconomics text. In contrast to the heavily normative emphasis of most writing, both legal and economic, on law, the book emphasizes positive analysis: the use of economics to shed light on the principles of the legal system rather than to change the system.

The book presupposes no previous acquaintance by the reader with economics.⁶ Law students with math block need not fear this book. The book presupposes no previous acquaintance with law, either; and although it will mean more to people who have studied at least some law than to those who have studied none, it can serve as an introduction to law for economists and other social scientists who would like to learn something about the legal system and perhaps do research on it.⁷ Finally, the book is as I have said a treatise on the economic analysis of law, but of course a shorter and less thorough treatise than it would be if it had not been written primarily for students. Although for the most part a summary of ideas contained in previously published scholarship, my own and many others' (cited in the reference section at the end of each chapter), the present edition, like its predecessors, contains a significant amount of original analysis.

Those familiar with the previous editions may be surprised how extensive are the revisions that I have made for this one. But not only has a great deal of law-and-economics scholarship been produced since 1977 (the date of the second edition); my experience as a federal court of appeals judge since 1981 has stimulated me to explore applications of economics in fields I had not gone deeply into as a law professor or consultant, and has caused me to modify some of my ideas about other

5. The principles of economics, excluding special principles used to analyze aggregate economic phenomena such as inflation, unemployment, economic growth, and business cycles; those phenomena are the subject of macroeconomics.

6. Those wishing to develop an acquaintance would be well-advised to begin with Jack Hirshleifer, *Price Theory and Applications* (3d ed. 1984); also very worthwhile, but more difficult, are Gary S. Becker, *Economic Theory* (1971), and George J. Stigler, *The Theory of Price* (3d ed. 1966).

7. Where there is a good text, accessible to nonlawyers, on the law discussed in a chapter, I cite it (occasionally them) in the first footnote of the chapter.

fields. I hope the result is a better book; I know it is a longer one, and this leads me to make a suggestion about teaching and learning. The book is too long to be taught in a quarter or semester course. For such a course, which in a law school is best offered either in the second half of the first year or the first half of the second year, I suggest trying to cover only Parts I through III (basic economic principles, the common law, and the regulation of monopolies) plus VI (the legal process, including procedure). I hope, however, that the student who takes such a course will read the rest of the book on his own time, for he (or she) will find the other parts both an aid to understanding the fields of law that they discuss and a reinforcement of his understanding of the parts covered in the course.

A number of friends and colleagues were kind enough to read and comment on various chapters: Douglas Baird, Mary Becker, Walter Blum, Christopher DeMuth, Frank Easterbrook, Robert Ellickson, Daniel Fischel, Walter Hellerstein, James Krier, William Landes, Saul Levmore, Michael Lindsay, Sam Peltzman, Carol Rose, Andrew Rosenfield, Steven Shavell, George Stigler, Geoffrey Stone, Cass Sunstein, and Robert Willis. I am most grateful to them; to Dwight Miller, Keith Crow, and Richard Cordray for research assistance; to the Law and Economics Program of the University of Chicago Law School for defraying the cost of that assistance; to Robert Mrofka, for the idea behind Figures 13.2 and 13.3 in Chapter 13; to my wife, Charlene, for editorial assistance; and to the economists who have most shaped my thinking about economics — Gary Becker, Ronald Coase, Aaron Director, William Landes, and George Stigler.

Richard A. Posner

October 1985

SUMMARY OF CONTENTS

PREFACE

xix

PART I LAW AND ECONOMICS: AN INTRODUCTION 1

CHAPTER 1	THE NATURE OF ECONOMIC REASONING	3
CHAPTER 2	THE ECONOMIC APPROACH TO LAW	19

PART II THE COMMON LAW 28

CHAPTER 3	PROPERTY	29
CHAPTER 4	CONTRACT RIGHTS AND REMEDIES	79
CHAPTER 5	FAMILY LAW	127
CHAPTER 6	TORT LAW	147
CHAPTER 7	CRIMINAL LAW	201
CHAPTER 8	THE COMMON LAW, LEGAL HISTORY, AND JURISPRUDENCE	229

PART III PUBLIC REGULATION OF THE MARKET 247

CHAPTER 9	THE THEORY OF MONOPOLY	249
CHAPTER 10	THE ANTITRUST LAWS	265
CHAPTER 11	THE REGULATION OF THE EMPLOYMENT RELATION	299
CHAPTER 12	PUBLIC UTILITY AND COMMON CARRIER REGULATION	317
CHAPTER 13	THE CHOICE BETWEEN REGULATION AND COMMON LAW	343

<i>PART IV</i>	<i>THE LAW OF BUSINESS ORGANIZATIONS AND FINANCIAL MARKETS</i>	<i>365</i>
<i>CHAPTER 14</i>	<i>CORPORATIONS (WITH A GLANCE AT LENDING AND BANKRUPTCY)</i>	<i>367</i>
<i>CHAPTER 15</i>	<i>FINANCIAL MARKETS</i>	<i>405</i>
<i>PART V</i>	<i>LAW AND THE DISTRIBUTION OF INCOME AND WEALTH</i>	<i>429</i>
<i>CHAPTER 16</i>	<i>INCOME INEQUALITIES, DISTRIBUTIVE JUSTICE, AND POVERTY</i>	<i>431</i>
<i>CHAPTER 17</i>	<i>TAXATION</i>	<i>453</i>
<i>CHAPTER 18</i>	<i>THE TRANSMISSION OF WEALTH AT DEATH</i>	<i>479</i>
<i>PART VI</i>	<i>THE LEGAL PROCESS</i>	<i>489</i>
<i>CHAPTER 19</i>	<i>THE MARKET, THE ADVERSARY SYSTEM, AND THE LEGISLATIVE PROCESS AS METHODS OF RESOURCE ALLOCATION</i>	<i>491</i>
<i>CHAPTER 20</i>	<i>THE PROCESS OF LEGAL RULEMAKING</i>	<i>509</i>
<i>CHAPTER 21</i>	<i>CIVIL AND CRIMINAL PROCEDURE</i>	<i>517</i>
<i>CHAPTER 22</i>	<i>LAW ENFORCEMENT</i>	<i>559</i>
<i>CHAPTER 23</i>	<i>THE ADMINISTRATIVE PROCESS</i>	<i>571</i>
<i>PART VII</i>	<i>THE CONSTITUTION AND THE FEDERAL SYSTEM</i>	<i>579</i>
<i>CHAPTER 24</i>	<i>THE NATURE AND FUNCTIONS OF THE CONSTITUTION</i>	<i>581</i>
<i>CHAPTER 25</i>	<i>ECONOMIC DUE PROCESS</i>	<i>589</i>
<i>CHAPTER 26</i>	<i>THE ECONOMICS OF FEDERALISM</i>	<i>599</i>
<i>CHAPTER 27</i>	<i>RACIAL DISCRIMINATION</i>	<i>615</i>
<i>CHAPTER 28</i>	<i>THE MARKETPLACE OF IDEAS AND THE PRIMACY OF POLITICAL OVER ECONOMIC RIGHTS</i>	<i>627</i>
<i>CHAPTER 29</i>	<i>THE FOURTH AMENDMENT</i>	<i>639</i>
<i>TABLE OF CASES</i>		<i>643</i>
<i>AUTHOR INDEX</i>		<i>647</i>
<i>SUBJECT INDEX</i>		<i>653</i>

TABLE OF CONTENTS

<i>PREFACE</i>	xix
----------------	-----

<i>PART I LAW AND ECONOMICS: AN INTRODUCTION</i>	<i>1</i>
--	----------

<i>CHAPTER 1 THE NATURE OF ECONOMIC REASONING</i>	<i>3</i>
--	----------

§1.1 Fundamental Concepts	3
§1.2 Value, Utility, Efficiency	11
§1.3 The Realism of the Economist's Assumptions	15
Suggested Readings	17
Problems	17

<i>CHAPTER 2 THE ECONOMIC APPROACH TO LAW</i>	<i>19</i>
--	-----------

§2.1 Its History	19
§2.2 Normative and Positive Economic Analysis of Law	20
§2.3 Criticisms of the Economic Approach	22
Suggested Readings	26

<i>PART II THE COMMON LAW</i>	<i>28</i>
----------------------------------	-----------

<i>CHAPTER 3 PROPERTY</i>	<i>29</i>
------------------------------	-----------

§3.1 The Economic Theory of Property Rights: Static and Dynamic Aspects	30
§3.2 Problems in the Creation and Enforcement of Property Rights; Herein of Wild Animals, Treasure Trove, Intellectual Property, Privacy, and Other Exotica	33
§3.3 Property Rights in Law and Economics: The Case of Broadcast Frequencies	39

§3.4	Future Rights	41
§3.5	Incompatible Uses	42
§3.6	Trespass and Eminent Domain	48
§3.7	Pollution; Nuisance and Easement Approaches	54
§3.8	Other Solutions to the Problem of Incompatible Land Uses; Herein of the Difference Between Property and Contract Rights and Between Injunctive and Damage Remedies	58
§3.9	Divided Ownership — Estates in Land	63
§3.10	Problems in the Transfer of Property Rights	67
§3.11	The Distributive Effects of Property Rights Assignments	71
§3.12	Public Lands	74
	Suggested Readings	75
	Problems	75
 <i>CHAPTER 4 CONTRACT RIGHTS AND REMEDIES</i>		 79
§4.1	The Process of Exchange and the Economic Roles of Contract Law	79
§4.2	Consideration	85
§4.3	Mutual Assent and Unilateral Contracts	88
§4.4	Mutual Mistake	90
§4.5	Contracts as Insurance — Impossibility and Related Doctrines and the Interpretation of Insurance Contracts	91
§4.6	Fraud	96
§4.7	Duress, Bargaining Power, and Unconscionability	101
§4.8	Fundamental Principles of Contract Damages	105
§4.9	Consequential Damages	114
§4.10	Penalties, Liquidated Damages, and Forfeitures	115
§4.11	Specific Performance	117
§4.12	Self-Help — Contract Conditions	119
§4.13	Implied Contracts	122
	Suggested Readings	123
	Problems	124
 <i>CHAPTER 5 FAMILY LAW</i>		 127
§5.1	The Theory of Household Production	127
§5.2	Formation and Dissolution of Marriage	130
§5.3	Consequences of Dissolution	134
§5.4	The Legal Protection of Children	137

Table of Contents**ix**

§5.5	Law and Population	143
	Suggested Readings	144
	Problems	145

<i>CHAPTER 6</i>	<i>TORT LAW</i>	<i>147</i>
------------------	-----------------	------------

§6.1	The Economics of Accidents and the Learned Hand	
	Formula of Liability for Negligence	147
§6.2	The Reasonable Man Standard	151
§6.3	Custom as a Defense	152
§6.4	Victim Fault: Contributory and Comparative	
	Negligence, Assumption of Risk, and Duties Toward	
	Trespassers	154
§6.5	Strict Liability	160
§6.6	Products Liability	165
§6.7	Causation and Foreseeability	167
§6.8	Joint Torts, Contribution, Indemnity	171
§6.9	Rescue: Liability Versus Restitution	174
§6.10	The Function of Tort Damages	176
§6.11	Damages for Loss of Earning Capacity	177
§6.12	Damages for Pain and Suffering, and the Problem of	
	Valuing Human Life	182
§6.13	The Collateral Benefits (Collateral Source) Rule	186
§6.14	Negligence With Liability Insurance and Accident	
	Insurance; No-Fault Automobile Accident	
	Compensation	186
§6.15	Intentional Torts	191
§6.16	Defamation	195
	Suggested Readings	197
	Problems	198

<i>CHAPTER 7</i>	<i>CRIMINAL LAW</i>	<i>201</i>
------------------	---------------------	------------

§7.1	The Economic Nature and Function of Criminal Law	201
§7.2	Optimal Criminal Sanctions	205
§7.3	Preventing Crimes: Multiple-Offender Laws, Attempt	
	and Conspiracy, Aiding and Abetting, Entrapment	213
§7.4	Criminal Intent	218
§7.5	Recklessness, Negligence, and Strict Liability Again	221
§7.6	The Defense of Necessity (Compulsion)	223
§7.7	The Economics of Organized Crime	224
	Suggested Readings	225
	Problems	226

<i>CHAPTER 8</i>	<i>THE COMMON LAW, LEGAL HISTORY, AND JURISPRUDENCE</i>	229
§8.1	The Implicit Economic Logic of the Common Law	229
§8.2	The Common Law, Economic Growth, and Legal History	233
§8.3	The Moral Content of the Common Law	238
§8.4	The Moral Form of Law	242
	Suggested Readings	244
	Problems	244
 <i>PART III</i>	 <i>PUBLIC REGULATION OF THE MARKET</i>	 247
<hr/> <i>CHAPTER 9</i>	<hr/> <i>THE THEORY OF MONOPOLY</i>	<hr/> 249
§9.1	The Monopolist's Price and Output	249
§9.2	Effect of Changes in Cost and Demand on the Monopoly Price	253
§9.3	Efficiency Consequences of Monopoly	254
§9.4	Price Discrimination	259
§9.5	Other Impediments to Monopolizing: Competition for the Market, Durability, New Entry	260
	Suggested Readings	262
	Problems	263
 <i>CHAPTER 10</i>	 <i>THE ANTITRUST LAWS</i>	 265
§10.1	Cartels and the Sherman Act	265
§10.2	Borderline Horizontal Agreements — Patent Agreements and the BMI-ASCAP Blanket Licenses	271
§10.3	Resale Price Maintenance	275
§10.4	Mergers to Monopoly and Oligopoly	277
§10.5	Monopoly Power	279
§10.6	Market Definition and Market Shares	281
§10.7	Potential Competition	283
§10.8	Predation	285
§10.9	Foreclosure, Tie-Ins, Barriers to Entry	289
§10.10	Boycotts; Herein of Monopsony	291
§10.11	Antitrust Damages	293
	Suggested Readings	296
	Problems	297

<i>CHAPTER 11</i>	<i>THE REGULATION OF THE EMPLOYMENT RELATION</i>	<i>299</i>
§11.1	The Special Treatment of Labor Monopolies	299
§11.2	The Economic Logic of the National Labor Relations Act	302
§11.3	Unions and Productivity	305
§11.4	Employment at Will	306
§11.5	Labor and Antitrust Law	307
§11.6	Minimum Wage and Related “Worker-Protective” Legislation	308
§11.7	Some Issues in Employment Discrimination on Grounds of Race, Sex, and Age	312
	Suggested Readings	315
	Problems	316
 <i>CHAPTER 12</i>	 <i>PUBLIC UTILITY AND COMMON CARRIER REGULATION</i>	 <i>317</i>
§12.1	Natural Monopoly	317
§12.2	Control of Profits and the Problem of Reasonable Return	321
§12.3	Some Other Problems Arising From the Attempt to Limit the Regulated Firm’s Profits	323
§12.4	Incentive Regulation	327
§12.5	Regulation of Rate Structure and of Entry	328
§12.6	Digression on Pay Television	333
§12.7	Taxation by Regulation (Internal Subsidization or Cross-Subsidization)	334
§12.8	Excessive Competition	337
§12.9	The Demand for Regulation	339
	Suggested Readings	340
	Problems	340
 <i>CHAPTER 13</i>	 <i>THE CHOICE BETWEEN REGULATION AND COMMON LAW</i>	 <i>343</i>
§13.1	The Theory of Optimal Regulation	343
§13.2	Consumer Fraud Revisited	346
§13.3	Mandated Disclosure	348
§13.4	Safety and Health	351
§13.5	Pollution Revisited — Taxation as Regulation	351
§13.6	Mandatory Container Deposits	358

§13.7	Cable Television: Problems of Copyright and Local Monopoly	359
	Suggested Readings	363
	Problems	364

<i>PART IV</i>	<i>THE LAW OF BUSINESS ORGANIZATIONS AND FINANCIAL MARKETS</i>	365
----------------	--	-----

<i>CHAPTER 14</i>	<i>CORPORATIONS (WITH A GLANCE AT LENDING AND BANKRUPTCY)</i>	367
§14.1	The Nature of the Firm	367
§14.2	Problems in Financing Business Ventures	368
§14.3	The Corporation as a Standard Contract	369
§14.4	Corporate Debt — Bankruptcy and Reorganization	373
§14.5	Piercing the Corporate Veil	379
§14.6	The Separation of Ownership and Control in the Modern Corporation	382
§14.7	The Transfer of Corporate Control	385
§14.8	The Fiduciary Principle	389
§14.9	Corporate Squeeze-Outs and the Competition in Laxity	390
§14.10	Insider Trading and the Problem of Entrepreneurial Reward	392
§14.11	Managerial Discretion and the Corporation's Social Responsibilities	393
§14.12	Corporate Criminality	397
§14.13	The Closely Held Corporation	399
§14.14	Public Utility Regulation Revisited	400
	Suggested Readings	401
	Problems	402

<i>CHAPTER 15</i>	<i>FINANCIAL MARKETS</i>	405
-------------------	--------------------------	-----

§15.1	Portfolio Design	405
§15.2	Diversification, Leverage, and the Debt-Equity Ratio	410
§15.3	Why Do Corporations Buy Insurance?	412
§15.4	Stock Picking and the Efficient-Market Hypothesis	413
§15.5	Monopoly Again	415
§15.6	Trust Investment Law and Market Funds	416
§15.7	Social Investing by Trustees	419
§15.8	The Regulation of the Securities Markets	420

§15.9	The Regulation of Banking	424
	Suggested Readings	426
	Problems	427

*PART V LAW AND THE DISTRIBUTION OF
INCOME AND WEALTH* 429

*CHAPTER 16 INCOME INEQUALITIES, DISTRIBUTIVE
JUSTICE, AND POVERTY* 431

§16.1	The Measurement of Inequality	431
§16.2	Is Inequality Inefficient?	434
§16.3	The Contract Theory of Distributive Justice	436
§16.4	The Costs of Poverty and the Limitations of Private Charity	438
§16.5	Unrestricted Cash Transfers Versus Benefits in Kind	441
§16.6	Wealth Redistribution by Liability Rules: The Case of Housing Code Enforcement	445
§16.7	Open-Ended Benefits in Kind	448
	Suggested Readings	448
	Problems	449

CHAPTER 17 TAXATION 453

§17.1	Taxation and Efficiency	453
§17.2	Conscription	454
§17.3	Excise Taxes	455
§17.4	Real Estate Taxes	458
§17.5	Corporate Income Taxation	459
§17.6	Personal Income Taxation: Introduction	461
§17.7	The Definition of Income	463
§17.8	Income Tax Deductions	466
§17.9	The Special Treatment of Capital Gains	469
§17.10	The Progressive Principle	472
	Suggested Readings	476
	Problems	476

CHAPTER 18 THE TRANSMISSION OF WEALTH AT DEATH 479

§18.1	Death (and Gift) Taxes	479
§18.2	The Problem of the “Dead Hand”	481
§18.3	The <i>Cy Pres</i> Doctrine	483