CHAPTER 2

THE ECONOMIC APPROACH TO LAW

§2.1 Its History

Until about 30 years ago, economic analysis of law was almost synonymous with economic analysis of antitrust law, though there was some economic work on tax law (by Henry Simons), corporate law (by Henry Manne), and public utility and common carrier regulation (by Ronald Coase and others). The records in antitrust cases provided a rich mine of information about business practices; and economists, who at the time were preoccupied with the question of monopoly, set about to discover the economic rationales and consequences of such practices. Their discoveries had implications for legal policy, of course, but basically what they were doing was no different from what economists traditionally have done—trying to explain the behavior of explicit economic markets.

The economic analysis of antitrust, and of other legal regulations of explicit economic markets, remains a prosperous field and receives considerable attention in this book. However, the hallmark of the “new” law and economics—the law and economics that is new within the last 30 years—is the application of economics to the legal system across the board: to common law fields such as torts, contracts, restitution, and property; to the theory and practice of punishment; to civil, criminal, and administrative procedure; to the theory of legislation and regulation; to law enforcement and judicial administration; and even to constitutional law, primitive law, admiralty law, family law, and jurisprudence.

The new law and economics began with Guido Calabresi’s first article on torts and Ronald Coase’s article on social cost.¹ These were the first

modern attempts to apply economic analysis systematically to areas of law that do not awavely regulate economic relationships. One can find earlier glimmerings of an economic approach to the problems of accident and nuisance law that Calabresi and Coase discussed, especially in the work of Pigou, which provided a foil for Coase's analysis; but the earlier work had made little impact on legal thought.

Coase's article introduced the Coase Theorem, which we met in Chapter 1, and, more broadly, established a framework for analyzing the assignment of property rights and liability in economic terms, thus opening a vast field of legal doctrine to fruitful economic analysis. An important, although for a time neglected, feature of Coase's article was its implications for the positive economic analysis of legal doctrine. Coase suggested that the English law of nuisance had an implicit economic logic. Later writers have generalized this insight and argued that many of the doctrines and institutions of the legal system are best understood and explained as efforts to promote the efficient allocation of resources—a major theme of this book.

A list of the founders of the "new" law and economics would be seriously incomplete without the name of Gary Becker. Becker's insistence on the relevance of economics to a surprising range of nonmarket behavior (including charity and love), as well as his specific contributions to the economic analysis of crime, racial discrimination, and marriage and divorce, opened to economic analysis large areas of the legal system not reached by Calabresi's and Coase's studies of property rights and liability rules.


5. The modern literature on property rights also reflects, however, the influence of Frank Knight's important early work. Some Fallacies in the Interpretation of Social Cost, 38 Q. J. Econ. 582 (1924); see §3.1 infra.


§2.2 Positive and Normative Economic Analysis of Law

Subsequent chapters will show how the insights of the pioneers have been generalized, empirically tested, and integrated with the insights of the "old" law and economics to create an economic theory of law with growing explanatory power and empirical support. The theory has normative as well as positive aspects. Although the economist cannot tell society whether it should seek to limit theft, the economist can show that it would be inefficient to allow unlimited theft and can thus clarify a value conflict by showing how much of one value—efficiency—must be sacrificed to achieve another. Or, taking a goal of limiting theft as given, the economist may be able to show that the means by which society has attempted to attain that goal are inefficient—that society could obtain more prevention, at lower cost, by using different methods. If the more efficient methods did not impair any other values, they would be socially desirable even if efficiency were low on the totem pole of social values.

As for the positive role of economic analysis of law—the attempt to explain legal rules and outcomes as they are rather than to change them to make them better—we shall see in subsequent chapters that many areas of the law, especially but not only the great common law fields of property, torts, crimes, and contracts, bear the stamp of economic reasoning. It is not a refutation that few judicial opinions contain explicit references to economic concepts. Often the true grounds of legal decision are concealed rather than illuminated by the characteristic rhetoric of opinions. Indeed, legal education consists primarily of learning to dig beneath the rhetorical surface to find those grounds, many of which may turn out to have an economic character. (Remember how broadly economics was defined in Chapter 1.) It would not be surprising to find that many legal doctrines rest on inarticulate gropings toward efficiency, especially since so many legal doctrines date back to the nineteenth century when a laissez-faire ideology based on classical economics was the dominant ideology of the educated classes.

What we may call the efficiency theory of the common law is not that every common law doctrine and decision is efficient. That would be highly unlikely, given the difficulty of the questions that the law wrestles with and the nature of judges' incentives. The theory is that the common law is best (not perfectly) explained as a system for maximizing the wealth of society. Statutory or constitutional as distinct from common law fields are less likely to promote efficiency, yet even they, as we shall see, are permeated by economic concerns and illuminated by economic analysis. Such analysis is also helpful in illuminating institutional or structural features of the legal system, including the role of precedent and the allocation of law enforcement responsibilities between private persons and public agencies.

But, it may be asked, do not the lawyer and the economist approach
the same case in such different ways as to guarantee a basic incompatibility between law and economics? X is shot by a careless hunter, Y, and sues. The only question in which the parties and their lawyers are interested and the only question the judge and jury will decide is whether the cost of the injury should be shifted from X to Y, whether, that is, it is “just” or “fair” that X should receive compensation. X’s lawyer will argue that it is just that X be compensated since Y was at fault and X blameless. Y’s lawyer may argue that X was also careless and hence that it would be just for the loss to remain on X. Not only are justice and fairness not economic terms, but the economist is not (one might think) interested in the one question that concerns the victim and his lawyer: Who should bear the costs of this accident? To the economist, the accident is a closed chapter. The costs that it inflicted are sunk. The economist is interested in methods of preventing future accidents that are not cost-justified and thus of reducing the sum of accident and accident-prevention costs, but the parties to the litigation have no interest in the future. Their concern is limited to the financial consequences of a past accident.

This dichotomy, however, is overstated. The decision in the case will affect the future, and so it should interest the economist, because it will establish or confirm a rule for the guidance of people engaged in dangerous activities. The decision is a warning that if one behaves in a certain way and an accident results, one will have to pay a judgment (or will be unable to obtain a judgment, if the victim). By thus altering the shadow price (of risky behavior) that confronts people, the warning may affect their behavior and therefore accident costs.

Conversely, the judge (and hence the lawyers) cannot ignore the future. Since the judge’s legal ruling will be a precedent influencing the decision of future cases, the judge must consider the probable impact of alternative rulings on the future behavior of people engaged in activities that give rise to the kind of accident involved in the case before him. If, for example, judgment is awarded to the defendant on the ground that he is a “deserving,” albeit careless, fellow, the decision will encourage similar people to be careless, a type of costly behavior. Thus, the frame of reference is expanded beyond the immediate parties to the case, justice and fairness assume broader meanings than what is just or fair as between this plaintiff and this defendant. The issue becomes what is just and fair result for a class of activities, and it cannot be sensibly resolved without consideration of the future impact of alternative rulings on the frequency of accidents and the cost of precautions. The ex ante perspective is not alien to the legal process after all. 1

§2.3 Criticisms of the Economic Approach

Economic analysis of law has aroused considerable antagonism, especially but not only among academic lawyers who dislike the thought that the logic of the law might be economics. We have already examined the criticisms that economics is reductionist (a criticism not limited to course to economic analysis of law) and that lawyers and judges do not speak its language. Another common criticism is that the normative underpinnings of the economic approach are so repulsive that it is inconceivable that the legal system would embrace them. This criticism may appear to confound positive and normative analysis, but it does not. Law reflects and enforces fundamental social norms, and how could those norms be inconsistent with the society’s ethical system? But is the Kaldor-Hicks concept of efficiency really so at variance with that system? Besides what was said in the first chapter, we shall see in Chapter 8 that, provided only that this concept is a component, though not necessarily the only or the most important one, of our ethical system, it may be the one that dominates the law as administered by the courts because of the courts’ inability to promote other goals effectively. And provided that efficiency is any sort of value in our ethical system, two normative uses of economics mentioned earlier—to clarify value conflicts and to point the way toward reaching given social ends by the most efficient path—are untouched by the philosophical debate.

Moreover, one should not reject economic analysis of law in toto merely because one is not convinced by the most aggressive version of that analysis. The most aggressive version argues that economics not only explains the rules and institutions of the legal system but also provides the ethically soundest guide to improving the system. One could believe that economics explained only a few legal rules and institutions but that it could be used to improve many of them, or that it explained many of them but regrettably so because economics is an immoral guide to legal policy, or even that
economic analysis of law had little explanatory or meliorative significance but was intellectually fascinating—and in any of these cases one would not want to shut this book quite yet!

Another recurrent criticism of the economic approach to law is that on the positive side it’s a flop because it has failed to explain every important rule, doctrine, institution, and outcome of the legal system. As yet it does not; that is true. But undue emphasis on puzzles, anomalies, and contradictions is misplaced when speaking of so recent and yet so fruitful a field of scholarship and also ignores an important lesson from the history of scientific progress: A theory, unless quite hopeless, is overturned not by pointing out its defects or limitations but by proposing a more inclusive, more powerful, above all more useful theory. The economic theory of law is the most promising positive theory of law extant. While anthropologists, sociologists, psychologists, political scientists, and other social scientists besides economists also make positive analyses of the legal system, their work is insufficiently rich in theoretical or empirical content to create serious competition for the economists. (The reader is challenged to adduce evidence contradicting this presumptuous, sweeping, and perhaps uninformed judgment.)

Still another criticism of the new law and economics—although it is better described as a reason for the disinterest with which the subject is regarded in some quarters—is that it manifests a conservative political bias. We shall see that its practitioners have found that capital punishment deters, legislation designed to protect consumers frequently ends up hurting them, no-fault automobile insurance is inefficient, securities regulation may be a waste of time, and so on. Findings such as these provide ammunition to the supporters of capital punishment and the opponents of the other policies mentioned. Yet economic research that provides support for liberal positions is rarely said to exhibit political bias. For example, the theory of public goods (see §16.4 infra) could be viewed as one of the ideological underpinnings of the welfare state but is not so viewed; once a viewpoint becomes dominant, it ceases to be perceived as having an ideological character. The criticism also overlooks a number of findings of economic analysts of law, discussed in subsequent chapters of this book—concerning right to counsel and standard of proof in criminal cases, bail, products liability, the application of the First Amendment to broadcasting, the social costs of monopoly, damages in personal-injury cases, the regulation of sex, and many others—that support liberal positions.

The economic approach to law is criticized for ignoring “justice.” One must distinguish between the different meanings of this word. Sometimes it means distributive justice, the proper degree of economic equality. Although economists cannot tell society what that degree is, they have much to say that is relevant—about the actual amounts of inequality in different societies and in different periods, about the difference between real economic inequality and inequalities in pecuniary income that merely offset cost differences or reflect different positions in the life cycle, and about the costs of achieving greater equality. These matters are discussed in Chapter 16.

A second meaning of justice, perhaps the most common, is—efficiency. We shall see, among other examples, that when people describe as unjust convicting a person without a trial, taking property without just compensation, or failing to make a negligent automobile driver answer in damages to the victim of his negligence, this means nothing more pretentious than that the conduct wastes resources (see further §8.3 infra). Even the principle of unjust enrichment can be derived from the concept of efficiency (§4.14 infra). And with a little reflection, it will come as no surprise that in a world of scarce resources waste should be regarded as immoral.

But there is more to notions of justice than a concern with efficiency. It is not obviously inefficient to allow suicide pacts; to allow private discrimination on racial, religious, or sexual grounds; to permit killing and eating the weakest passenger in the lifeboat in circumstances of genuine desperation; to force people to give self-incriminating testimony; to fling prisoners; to allow babies to be sold for adoption; to allow the use of deadly force in defense of a pure property interest; to legalize blackmail; or to give convicted felons a choice between imprisonment and participation in dangerous medical experiments. Yet all these things offend the sense of justice of modern Americans, and all are to a greater or lesser (usually greater) extent illegal. An effort will be made in this book to explain some of these prohibitions in economic terms, but most cannot be; there is more to justice than economics, a point the reader should keep in mind in evaluating normative statements in this book. There may well be definite although wide boundaries on both the explanatory and reformative power of economic analysis of law. Always, however, economics can provide value clarification by showing the society what it must give up to achieve a noneconomic ideal of justice. The demand for justice is not independent of its price.
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