The Economics of Law

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Dr Veljanovski was the first economist appointed to a lectureship in a law department at a British university. He has written many books and articles on industrial economics, economic reform and law and economics, including *Selling the State: Privatisation in Britain* (1988), *The Economic Approach to Law* (1982) and *Economic Principles of Law* (2007). He is a member of the editorial boards of *United Kingdom Competition Law Reports*, *Journal of Network Industries* and *Journal des Economistes et des Etudes Humaines*, and the advisory committees of the Erasmus Programme in Law and Economics, Centre for the Study of the New Institutional Economics (University of Saarland), and the Centre for Law and Economics (Australian National University).

FOREWORD

When the Editorial and Programme Director of the Institute of Economic Affairs asked me to write the foreword to this new edition of Cento Veljanovski's *The Economics of Law*, I accepted his invitation immediately and with great pleasure. A book I had long wanted to see back in print, to benefit both new generations of students and practising lawyers and economists as yet unfamiliar with the area, would soon once again be available.

Dr Veljanovski's book was first published in 1990, and a second impression appeared in 1996. Since then there has been little in the area for the British reader. Introductory texts have been aimed primarily at the US market, a meaningful concept in this context, although not when applied to many other kinds of textbook – while US and English law have common origins there are many differences. Further, these texts have been longer and more detailed than anyone wanting simply a guide to why the subject is so important, and so interesting, would actually need. This substantially revised edition of *The Economics of Law* is therefore greatly welcome.

Why exactly is the subject so important and so interesting? Law and economics are almost inevitably intertwined. In a world with only one person – Robinson Crusoe – economics would still have a role. Crusoe has to decide how much of his time to spend making a better fishing rod, an activity that delays his going to

catch fish. Resources, in other words, are always scarce and decisions have to be made about how to allocate them among various activities. In that world there would be no need for law. But give Crusoe a helper – Friday – and immediately law is needed to deal with who can use what. How much is Friday to get for his labours if he is a helper? Or, if he is a neighbour who just happens to find a fish Crusoe has caught, is he entitled to fillet, cook and eat it? The moment there is more than one person in the world, efficient resource allocation requires the definition and enforcement, even if only by custom, of property rights. To see why, consider again Crusoe's fishing rod versus fish decision. If he cannot rely on getting the share he expects of the fish he catches, why should he even consider spending effort to improve his fishing technology?

One role, then, of the discipline of law and economics is to explore whether laws promote economically efficient outcomes and, if they do not, to suggest how they can be changed to do so, always provided the cost of the change falls short of the benefits.

To an extent economists view law as, to quote Dr Veljanovski, 'a giant pricing machine'. This view, he says, 'leads [economists] to a fundamentally different view of law which, while not alien to lawyers, is not central'. In contrast to that, lawyers, he writes, see law as 'a set of rules and procedures'. They take a 'retrospective view', and begin with a dispute that needs to be resolved. It is therefore 'natural that [the lawyer] should focus on the question of how [the dispute] is to be resolved and how the solution affects the welfare of the parties directly involved'.

In Chapter 4, 'The economic approach', it is shown very clearly how this is an apparent rather than a real conflict. Dr Veljanovski's demonstration draws on a famous article by Ronald Coase, which showed that if two parties, each of whom is affected

by an action of the other, can negotiate with each other, then however a court decides in a dispute will not matter in terms of what actually happens. Negotiation will lead the parties to the least-cost outcome.

Dr Veljanovski uses this to illustrate some important propositions – economics matters not only when financial costs are involved: mutual incompatibility not 'the physical causation of harm' is the basis of harmful interactions between activities; the law has no allocative effect when transaction costs are trivial; and that when such costs are not trivial the law can have significant effects on 'economic activity and behaviour'.

Economic activity and behaviour, it must be emphasised, includes what we would call crime.[1] Economics can guide us on the combination of penalties and risk of enforcement that brings the least-cost result. How severe, for example, should fines or other sentences be? There is a right answer to that question. It still awaits discovery but, as Dr Veljanovski shows, we can get nearer it with the use of economic analysis than we can without such help.

Economics also extends into the analysis of regulation – very important now as regulation has increased so greatly in Britain in recent years. It can help us analyse and often improve competition law. In these areas we can use economics to appraise and refine parliamentary and regulatory decisions. Further, we can look not only at decisions but also at processes and rules, asking whether these will tend to produce efficient outcomes even in situations

1 I do not venture here into discussion of whether crime is a construct of law; but I would maintain that while it is defined by law the definitions have economic foundations. If something is deemed a crime it must be thought to cause harm, and that is a cost. Different societies may, of course, differ over what is harm, and others may think the views of some other societies bizarre. Saying that is not the end of the matter – but going farther would be too substantial a digression.

unknown when the rule or regulation was framed. Economics also has a role in comparatively simple matters, showing how, for example, to calculate appropriate compensation resulting from a decision over liability for harm.

Strikingly, economically efficient outcomes come not only from the conscious application of economic analysis to the framing of laws; law has in many areas evolved towards producing efficient outcomes. This conclusion, startling to some, was argued by Guido Calabrisi in 1967, and then by Richard Posner in a series of papers and books. More details of these, and of the work of the economists who also helped open up the joint study of law and economics, can be found in Chapter 2 of Dr Veljanovski's book.

As I hope I have made clear, this is an important book. It is to be recommended without hesitation to any economist or lawyer who wants to find out about the discipline that combines these two fields of study. I would expect that any such reader would soon be engrossed in a book that is at once enjoyable, well written, informative and useful. And I would predict that any reader who opened it not expecting to be persuaded of the virtues of the approach described and advocated by Dr Veljanovski would soon be reading avidly, and would end the book a convert.

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August 2006

SUMMARY

- Economic analysis is increasingly applied beyond its traditional precincts of the marketplace and the economy. One area where this has happened is the economic approach to law. This is the application of economic theory, mostly price theory, and statistical methods to examine the formation, structure, processes and impact of the law and legal institutions.
- Economics and the law were connected in the work of many classical economists, but the disciplines became separated until the work of a number of Chicago School economists and public choice theorists in the second half of the twentieth century applied economic analysis to areas that had come to be deemed beyond the realm of economics.
- The economics of law is concerned with laws that regulate economic activity – those laws which affect markets, industries and firms, and economic variables such as prices, investment, profits, income distribution and resource allocation generally – but it also goes well beyond these areas to examine fundamental legal institutions.
- The economics of law stresses that the value of goods and services depends crucially on the 'bundle of legal rights' that is transferred with them, and that markets trade in these legal rights.
- The law prices and taxes individual human behaviour and therefore influences that behaviour. The economic approach to the law is more concerned with the way the law affects the choices and actions of all potential litigants and individuals likely to find themselves in similar circumstances, rather than the effect of particular legal decisions on the welfare of the parties to a dispute.
- Economics places at the forefront of discussion the costs and benefits of the law, considerations that will always be relevant when resources are finite. All too often, lawyers (as well as politicians, pressure groups and civil servants) discuss the law as if it were costless. Economics informs us that nothing is free from the viewpoint of society as a whole.
- Economics offers a means of evaluating the costs and benefits of different laws by attributing monetary values to different harms, outcomes and consequences. The economist uses the word 'costs' where the lawyer would use 'interests', but the economist's balancing of costs and benefits is no different from the judgmental process engaged in by the courts in resolving most legal disputes.
- Application of the economic approach to competition and antitrust law shows that such law is often founded upon a misunderstanding of the nature of markets, economic efficiency and competition. For example, the EU Commission has often treated innovation as a competition problem and first mover advantage as dominance, yet economic analysis shows that these are natural phenomena that are intrinsic to healthy market competition.

- Economic analysis has also shown that much regulation does not occur simply as a response to market failure, but can often be explained as a result of rent-seeking by already powerful special interests. Moreover, economics can show that regulation is often a barrier to competition and may impose greater costs than the harm it was intended to ameliorate.
- Laws exist for a purpose; they are not ends in themselves. They seek to guide, control, deter and punish. It follows that the study of law must, almost by definition, be broadened to include an understanding of its justification and effects. Economics provides an established approach to examine the justification and effects of the law beyond what may be possible by a conventional legal approach.

TABLES, FIGURES AND BOXES

The Economics of Law

1 INTRODUCTION

Increasingly, economics is being extended beyond its traditional precincts of the marketplace and the economy. One endeavour that has gained respectability is the economic approach to law. This is the application of modern price theory and empirical techniques to the analysis, interpretation, assessment and design of laws, legal procedures and institutions.

When the first edition of this Hobart Paper was written in 1990 the economics of law was struggling in Europe, both as an intellectual discipline and as a basis for public policy and legal reform. Today there is a greater awareness of the benefits of private property rights and markets, and the disadvantages and inefficiency of bureaucracy and regulation as means of coordinating the economy. Mainstream economics and legal texts now include economic analyses of the laws and institutions, and there is a greater acknowledgement of the need for and benefits of 'efficient' laws and markets. In some areas, such as utility regulation and competition and merger laws, economics has had a profound effect. The economic approach is not simply seen as just another interesting perspective in these areas of law, but as an essential part of the law itself! This has given a practical impetus for the wider acceptance of the economic approach to areas where the economic content and relevance of economics are not as obvious.

'A harmful disciplinary divide'

It is important not to exaggerate the influence that economics has had on law and lawyers. For far too long an unnecessary and positively harmful disciplinary divide between law and economics has existed and still persists today. Both disciplines suffer from what Veblen called 'trained incapacity'.

Lawyers and policy-makers have generally been economically illiterate and frequently innumerate. The English legal fraternity is wary of theory, contemptuous of experts and academics, and reluctant to accept the idea that other disciplines have something valuable to say about 'law'. To the economist, the approach of lawyers is viewed as excessively descriptive and formalistic. On the occasions when they do venture to comment on legal reform or even the goals and effects of existing laws, their conclusions appear ad hoc rationalisations, ethical and moralistic value judgements or simply assertions based on dubious casual empiricism. The economics editor of the Australian *Sydney Morning Herald* captured the lawyers' approach in the characteristic bluntness of his countrymen when he attacked an Australian Law Reform Commission proposal as:

> … a highly interventionist remedy, typical of the legal mind. It ignores many of the economic issues involved and falls back on the lawyer's conviction that all of the world's problems can be solved if only we had the right laws. Finding a lawyer who understands and respects market forces is as hard as finding a baby-wear manufacturer who understands and respects celibacy. The legally trained mind cannot grasp that it is never possible to defeat market forces, only to distort them so they pop up in unexpected ways.[1]

1 *Sydney Morning Herald*, 25 May 1981.

Box 1 **Law without economics – 'a deadly combination'**

'Judges move slower than markets but faster than the economics profession, a deadly combination.'

Judge F. Easterbrook (1987)

'A lawyer who has not studied economics … is very apt to become a public enemy.'

Justice Brandeis (1916)

'… every lawyer ought to seek an understanding of economics. There we are called on to consider and weigh the ends of legislation, the means of attaining them, and the cost. We learn that for everything we have to give up something else, and we are taught to set the advantage we gain against the other advantage we lose and to know what we are doing when we elect.'

Justice O. W. Holmes (1897)

'[Economics] is a powerful, and quite general tool of analysis that everybody who thinks and writes about law uses, consciously or not … it provides a convenient starting point for a general theory of law in society. It also – and this point must be stressed – has a strong empirical basis, and a basis in common sense. All about us is ample evidence that the system does use its pricing mechanism (in the broadest sense) to manipulate behaviour, and pervasively.'

Professor L. Friedman (1984)

'For the rational study of the law, the black letterman may be the man of the present, but the man of the future is the man of statistics and the master of economics.'

Justice O. W. Holmes (1897)

'Just as other law makers would not dream of now performing their functions in disregard of the economic factor, so courts in their function of declaring, clarifying and extending legal principle must take seriously the economic consequences of what they are doing.'

Justice M. Kirby (2005)

Economists, too, must shoulder considerable criticism. The general inclination was and still is to treat the law as datum. Karl Llewellyn, a noted legal scholar, touched on this many years ago: '… the economist takes … [the law] for granted. Law exists. If it serves economic life well, he has ignored it; if ill, he has pithily cursed it and its devotees, without too great an effort to understand the reason of disservice'.[2]

The economic approach to law

The economics of law can be defined rather crudely as the application of economic theory, mostly price theory, and statistical methods to examine the formation, structure, processes and impact of the law and legal institutions. No consensus has yet emerged, nor do economists possess a unified theory of law. Nevertheless, in the last several decades it has developed into a distinct field of study with its own specialist scholars, journals[3] and texts, with every indication that interest in the field is growing.

2 K. N. Llewellyn, 'The effect of legal institutions upon economics', *American Economic Review*, 1925, 13: 665–83.

3 Most notably *Journal of Law and Economics*, *Journal of Legal Studies*, *International Review of Law and Economics* and *Journal of Law, Economics and Organization*.

One branch of the economics of law is concerned with laws that regulate economic activity. It examines laws that affect markets, industries and firms, and economic variables such as prices, investment, profits, income distribution and resource allocation generally. It includes competition law (antitrust), industry or utility regulation (the regulation of the privatised utilities and state-owned industries), company, securities, tax, trade, investor and consumer protection laws. This application has grown over the last decade as supply-side reforms have led to the privatisation and liberalisation of industries.

The application of economics to the law is not confined to those areas of law that directly affect markets or economic activity. It goes well beyond these to examine fundamental legal institutions. The more innovative extension of economics is the so-called economics of law or law-and-economics, which takes as its subject matter the entire legal and regulatory systems irrespective of whether or not the law controls economic relationships. It looks in detail at the effects and the structure of the legal doctrines and remedies that make up existing laws. This branch of the economic approach to the law is often seen as synonymous with the analysis of the common law – judge-made law on contract, property and tort (the area of the common law that deals with unintentional harms such as accidents and nuisance) – and family and criminal laws, and many other areas such as legal procedure.

Outline of the book

This Hobart Paper provides an overview of the essential ingredients of the economic approach to law and examples of its applications. The discussion begins in Chapter 2 by briefly outlining the

development of the economic approach to law. In Chapter 3 the differences between economic and legal reasoning are discussed. It shows that the economist sees law as a 'giant pricing machine' – laws act as prices or taxes – which provides incentives that affect behaviour and actions – rather than sharing the lawyers' perspective of law as a set of rules and remedies. It is this perspective which marks out the economists' contribution to legal analysis. Chapter 4 sets out the basic 'tools' of the economic approach, most notably the theory of rational choice that underpins the economists' incentive analysis, and the concepts of opportunity costs and economic efficiency, which are central to the economic theory of law and which allow economists to quantify the costs and benefits of laws and legal change. The economic approach is then applied to the calculation of personal injury damages, torts and crime (Chapter 5). This is followed by an overview of the economic approach to competition law (Chapter 6), and regulation, i.e. public and administrative laws (Chapter 7).

2 A SHORT HISTORY

The marrying of economics and law is not new. 'Economic' approaches to law can be found in the utilitarianism of Cesare Bonesara (1764)[1] and Jeremy Bentham (1789);[2] the political economy of Adam Smith (1776)[3] and Karl Marx (1861);[4] and the American Institutionalist school most associated with the work of John R. Commons (1929).[5] Indeed, contemporary economics as a subject grew out of the moral and political philosophy of Adam Smith, the founder of modern economics. Smith's *Wealth of Nations* was only part of a more general theory embracing moral philosophy, economics and the law.[6] Anglo-American common law was also profoundly affected by the political economy of the eighteenth century. Judges, politicians and political economists formed an intellectual circle in which views were openly discussed and shared, and one sees in many legal judgments and judicial writings of the period an appreciation, if not the application, of the economic approach of the time.

1 C. Bonesara, *An Essay in Crime and Punishment*, 1764.
2 J. Bentham, *An Introduction to the Principles of Morals and Legislation*, 1789.
3 A. Smith, *The Wealth of Nations*, 1776.
4 K. Marx, *Das Kapital*, 1861.
5 J. R. Commons, *Legal Foundations of Capitalism*, Macmillan, New York, 1924.
6 His *Lectures on Jurisprudence* were, unfortunately, never completed.

Disciplinary divides

Despite this pedigree, the economic study of law and institutions fell into disrepute among Anglo-American economists and lawyers particularly after World War II. The economists' neglect can be attributed to two principal factors. First, many North American economists associated the study of law and organisations with Institutionalism, which they viewed as overly descriptive, and little more than a school of criticism that lacked a coherent theory. Thus, in 1959, Henry Houthakker, a respected economist, was able to write:

> The economic analysis of institutions is not highly regarded or widely practised among contemporary economists. The very word 'institution' now carries unfavourable associations with the legalistic approach to economic phenomena that were respectable during the first three decades of this century. There is little reason to regret the triumphant reaction that swept institutionalism from its dominant place. Nevertheless, economics can still learn much from the study of institutions. The analytical problems that arise are often both a challenge to conventional theory and a useful reminder of the relativity of accepted doctrine.[7]

The second reason for the economist's neglect lies in the transformation of economics from an a priori to an empirical science. The growing influence of positivism in economics, coupled with the increasing use of mathematics[8] and statistical analysis,

7 H. S. Houthakker, 'The scope and limits of futures trading', in M. Abramovitz et al. (eds), *Allocation of Economic Resources*, Stanford University Press, California, 1959, p. 134.

8 Samuelson's classic article on public goods illustrated in three pages the power of mathematics: P. A. Samuelson, 'The pure theory of public expenditure', *Review of Economics & Statistics*, 1954, 36: 387–9.

directed the economist's attention to areas of research where 'hard' data could be found. Institutions and law appeared to defy both mathematical modelling and easy empirical analysis, and were therefore ignored.

Indeed, the mathematical approach progressively took precedence over empirical analysis, as economics become a mathematical fantasia where the honours went to those versed in calculus, topology, set theory, game theory, linear algebra and the like. 'Page after page of the professional economic journals', observed Wassily Leontief, a Nobel Prize-winner in economics, in the early 1980s, 'are filled with mathematical formulae leading to precisely stated but irrelevant conclusions.'[9] The view was shared by one of the founders of modern institutional economics, Ronald Coase, who once quipped: 'In my youth it was said what was too silly to be said may be sung. In modern economics it may be put into mathematics.'[10]

Among lawyers the reluctance to engage in interdisciplinary teaching and research arose from more pragmatic considerations. The first, and perhaps principal, reason is the influence exerted by practitioners on legal education. Law, unlike economics, is a profession. A law degree is a professional qualification primarily designed to equip the student for legal practice, and hence legal education in the UK and most other countries must train the lawyer to ply his or her trade. Indeed, before World War II many English university law courses were taught by part-time practising lawyers. The subservience of the study of law to the demands of the practising profession in the UK placed severe limitations on

9 *The Economist*, 17 July 1982.

10 R. H. Coase, *The Firm, the Market and the Law*, University of Chicago Press, Chicago, 1988.

the ability of legal education to explore the wider context of the law, and bred hostility towards attempts to broaden the base of legal education. Second, legal education, particularly the case method which requires students to study hundreds of cases, is not conducive to the ready acceptance of the social science approach, which seeks to identify generalities rather than the peculiarities of cases that fascinate the legal mind.

The development of the economic approach

The 1960s and 1970s were the formative decades of the law-and-economics movement. During this period a number of separate but related efforts occurred largely within the economics profession which reflected a growing dissatisfaction with the ability of economics to adequately explain basic features of the economy and the way that the economy and industry worked. These centred both on extending economics to explain the nature and effects of regulation, and reformulating the basic conceptual structure of economics itself. It is interesting to note that apart from the work of Guido Calabresi, the building blocks of the economics of law had little to do with explaining and understanding law, and a lot to do with improving the economists' understanding of how the economic system works.

The Chicago School

The growing interest in law-and-economics is intimately associated with, though by no means confined to, the writings of members of the law and economics faculties of the University of Chicago. The 'Chicago School's' approach to economics and law is hard to define in any specific way, although many have cast

it in an ideological hue as 'free market economics'. Most would agree, however, that its hallmark is the belief that simple market economics has extraordinary explanatory power in all fields of human and institutional activity. It applies the simple tenets of rational maximising behaviour to all walks of life to elicit testable propositions about the way people and institutions will react to changes in their environment, and to construct proposals for legal reform based on the criterion of economic efficiency.

The work of Gary Becker best epitomises this approach, even though its focus has not been law. Beginning with the economic analysis of labour market discrimination, Becker has applied economics to a wide variety of non-market behaviour such as crime (see Chapter 5), politics, education, the family, health and charity.[11]

The Chicago programme in law-and-economics dates back to the early 1940s when Henry Simons was appointed to the law faculty. After Simons's death in 1947, Aaron Director took over his teaching responsibilities and in 1949 was appointed professor in economics in the Law School. Director exerted a considerable intellectual influence on the economics of antitrust through the work of his students, such as Bowman, Bork and Manne,[12] which was later taken up by Posner, Easterbrook, Landes and others. The Chicago School of antitrust has had a profound effect not only on

11 G. S. Becker, *The Economics of Discrimination*, University of Chicago Press, Chicago, 1957; G. S. Becker, *The Economic Approach to Human Behavior*, University of Chicago Press, Chicago, 1976; G. S. Becker, *A Treatise on the Family*, Harvard University Press, Cambridge, MA, 1981.

12 Two important statements of Chicago antitrust economics are R. H. Bork, *The Antitrust Paradox – A Policy at War with Itself*, Basic Books, New York, 1978; R. A. Posner, *Antitrust Law – An Economic Perspective*, University of Chicago Press, Chicago, 1976.

thinking about the purpose of competition law, but also on the law itself (Chapter 6). Its impact was felt elsewhere, particularly in corporate and securities law, such as in Henry Manne's development of the concept of the 'market for corporate control', and more controversially his defence of insider trading.[13] The work on the law and economics of antitrust, coupled with the problem-solving orientation of Chicago economists, provided the impetus for a more general economic study of law. In 1958, the law-and-economics programme at Chicago entered a new phase with the founding of the *Journal of Law and Economics* under the editorship first of Aaron Director and then of Ronald Coase.

Public choice and regulation

In the 1960s a small group of economists studying fiscal policy and taxation began to question the relevance of orthodox economics. The prevailing 'market failure' approach simply did not yield policy proposals that governments followed, nor did it explain the behaviour of bureaucrats and politicians. These economists, drawing on the work of earlier Continental economists such as Wicksell, Lindahl and others, began to incorporate government and bureaucracy into their models.

This led to the development of public choice, or the 'economics of politics' (also known as the 'Virginia School'). Public choice theorists, such as James Buchanan and Gordon Tullock, made government behaviour subject to the same self-regarding forces as those found in markets. Beginning with Downs's *An Economic*

13 H. G. Manne, 'Mergers and the market for corporate control', *Journal of Political Economy*, 1965, 73: 110–20; H. G. Manne, *Insider Trading and the Stock Market*, Free Press, New York, 1966.

Theory of Democracy[14] and Buchanan and Tullock's *The Calculus of Consent*,[15] economists began to explain political and bureaucratic behaviour by building on the economic postulate that politicians and civil servants are principally motivated by self-interest. This work had both normative (what should be) and positive (what is) limbs. Normative public choice theory sought to set out legitimate limits to the state in a free society based on individualistic principles and constitutions. Positive public choice sought to develop explanatory theories, most notably the theory of rent-seeking,[16] and to test these against the facts and more rigorous statistical analysis.

The increasing importance of government intervention in the US economy led other economists to model and measure the effects of regulation on industry. The classic articles by Averch and Johnson,[17] Caves,[18] and Stigler and Friedland[19] published in the 1960s mark the beginning of the rigorous and quantitative attempts by economists to model public utility regulation, and more importantly to determine the impact of these laws. Another landmark was Alfred Kahn's *The Economics of Regulation*, published in two volumes in 1970 and 1971.[20]

14 Harper & Row, New York, 1957.

15 University of Michigan Press, Ann Arbor, 1962; G. Tullock, *The Vote Motive*, IEA, London, 1976.

16 G. Tullock, 'The welfare cost of tariffs, monopoly, and theft', *Western Economics Journal*, 1967, 5: 224–32.

17 H. Averch and L. Johnson, 'Behavior of the firm under regulatory constraint', *American Economic Review*, 1962, LII: 1052–69.

18 R. Caves, *Air Transport and Its Regulators: An Industry Study*, Harvard University Press, Cambridge, MA, 1962.

19 G. J. Stigler and C. Friedland, 'What can regulators regulate?: the case of electricity', *Journal of Law and Economics*, 1962, 5: 1–16.

20 A. E. Kahn, *The Economics of Regulation: Principles and Institutions*, vol. I (1970), vol. II (1971); reprinted by MIT Press, Cambridge, MA, 1988.

George Stigler[21] and others went farther to develop a positive theory to explain the nature and growth of regulation. Stigler argued that governments were unlikely to be interested in economic efficiency or some broadly defined concept of the public interest. His central hypothesis was that regulation was secured by politically effective interest groups, invariably producers or sections of the regulated industry, rather than consumers. 'As a rule', argued Stigler, 'regulation is acquired by industry and is designed and operated primarily for its benefit by redistributing income in favour of the regulated industry in return for electoral support for politicians who engineer the redistribution.' Stigler's 'capture theory', together with work in the area of public utilities, stimulated economists in the 1970s to undertake empirical studies of the effects of regulation on industrial performance.

Property rights theory

The early work on property rights by Alchian[22] and Demsetz[23] added an explicit institutional dimension to the extension of economics. Economic theory had hitherto operated in an institutional vacuum, focusing on the production, distribution and consumption of physical goods and services. Property rights theorists stressed that the value of goods and services depends

21 G. J. Stigler, 'The theory of economic regulation', *Bell Journal of Economics and Management Science*, 1971, 2: 3–21.

22 A. A. Alchian, *Some Economics of Property Rights*, Rand Paper no. 2316, Rand Corporation, Santa Monica, CA, 1961; *Pricing and Society*, IEA, London, 1967.

23 H. Demsetz, 'Some aspects of property rights', *Journal of Law and Economics*, 1964, 9: 61–70; 'Toward a theory of property rights', *American Economic Review*, 59: 347–59; 'Toward a theory of property rights II: the competitiveness between private and collective ownership', *Journal of Legal Studies*, 1969, 31: S653–S672. Also Y. Barzel, *Economic Analysis of Property Rights*, 2nd edn, Cambridge University Press, Cambridge, 1997.

crucially on the 'bundle of legal rights' transferred with them, and that markets trade in these legal rights. Clearly, the price of a freehold property differs from that of a leasehold or tenancy, and these different types of ownership arrangements affect the value of land and the efficiency with which it is used. Property rights theorists sought to redefine economics as the study of how variations in 'bundles of property rights' affected prices and the allocation of resources. The approach also identified market failure with the absence of enforceable property rights, and specifically common or open access resources which allowed the overexploitation of the environment, oceans and natural resources. This led to property rights solutions in place of so-called command-and-control intervention to curb overuse and maximise efficiency.

Property rights theorists went farther to posit a dynamic theory of legal evolution and development. Their models 'predicted' that the creation and development of property rights were influenced by economic considerations. In a dynamic economy, new cost-price configurations are generated which provide an opportunity for restructuring, and in particular 'privatising', property. Thus, all other things being equal, the more valuable the prospective property rights, or the lower the costs of defining and enforcing new rights, the more likely it is that new rights will be defined.[24]

Coase and cattle

Perhaps the most important contribution of this period to the conceptual foundations of the economic approach to law and economics itself was Ronald Coase's 'The problem of social costs',[25]

24 F. A. Hayek, *Law, Legislation, and Liberty*, 3 vols, University of Chicago Press, Chicago, 1973–9.

25 *Journal of Law and Economics*, 1960, 3: 1–44.

published in 1960. Coase, although not a lawyer, used legal cases to develop several themes that were central to economic theory, and helped bridge the gap between law and economics, although the latter was not his purpose.

The primary purpose of the paper was to correct what Coase saw as a fundamental flaw in the way economists approached questions of public policy.[26] Economists had hitherto given policy advice on the basis of the concept of market failure. Typically, a departure from a model of a perfectly competitive market constituted a prima facie case for government intervention (often referred to as the Pigovian approach after A. C. Pigou, an early-twentieth-century economist). In this analysis government was treated as a costless corrective force, solely concerned with the pursuit of economic efficiency or the public interest. Coase objected to this view, arguing that realistic policy could be devised only if each situation was subjected to detailed investigation based on comparing the total costs and benefits of actual and proposed policy alternatives. In practice both the market and the non-market solutions were imperfect and costly, and these had to be dealt with on an equal footing when deciding which policy to pursue. This is not what economists habitually did, nor do many do so now. As Coase emphasised in 'Social costs', and his earlier equally influential paper on the nature of the firm,[27] the reason why markets appeared to fail was because they were costly to use, i.e. they had high transactions costs. Similarly, government intervention had

26 Coase's paper is the most cited paper in US law journals, outstripping the next most cited article two to one; F. R. Shapiro, 'The most-cited law review articles revisited', *Chicago Kent Law Review*, 1996, 71: 751–79.

27 R. H. Coase, 'The theory of the firm', *Economica*, 1937, 4: 386–405; reprinted in R. H. Coase, *The Firm, the Market and the Law*, University of Chicago Press, Chicago, 1988.

imperfections, costs and created distortions, and was justified only if these were less than the transactions costs of using the market and generated net benefits. The relevant comparison was not between ideals but between feasible, imperfect and costly alternatives. This set the scene for a 'government failures' framework comparable to that of market failure, or what Harold Demsetz was later to call the 'comparative institutions approach'.[28]

Coase's article is famous for another reason. He elaborated a proposition that later became known as the 'Coase Theorem', using trespassing cattle as an example, and further illustrated by English and US nuisance cases. Coase argued that the legal position on whether a rancher or a farmer should be 'liable' for the damages caused by trespassing cattle trampling wheat fields would not affect the efficient outcome provided that transactions costs were zero. The Coase Theorem holds that in a world where bargaining is costless, property rights will be transferred to those who value them the highest. Moreover, Coase claimed that the amount of damaged wheat would be the same whether the law held the rancher liable for the damages or not, provided that the parties could get together to bargain relatively cheaply. The only impact of the law was on the relative wealth of individuals. That is, potential gains-from-trade, and not the law, determined the allocation of resources. This counter-intuitive conclusion and its implication for policy analysis are explained in more detail in Chapter 4.

Coase, like property rights theorists, also stressed that the presence of positive transactions costs could help explain otherwise puzzling economic and institutional features of the

28 H. Demsetz, 'Information and efficiency: another viewpoint', *Journal of Law and Economics*, 1969, 12: 1–22.

economy. The development of contracts, laws and institutions could be seen as attempts to economise on transactions costs where they were a less costly way of organising economic activity.

Calabresi's costs of accidents

An article by Guido Calabresi, then of Yale University, titled 'Some thoughts on risk distribution and the law of torts',[29] was the first systematic attempt by a lawyer to examine the law of torts from an economic perspective. Calabresi argued that the goal of accident law was to 'minimise the sum of the costs of accidents and the costs of preventing accidents'. He later refined this axiom into a theory of liability for accident losses. According to Calabresi, the costs of accidents could be minimised if the party that could avoid the accident at least cost was made liable for the loss. This Calabresi called the 'cheapest-cost-avoider' rule.[30] His idea is simple to illustrate (ignoring for simplicity the random nature of accidents). A careless driver's car collides with a pedestrian, inflicting expected damages totalling £200. It is discovered that the accident resulted from the driver's failure to fit new brakes costing £50. Clearly, road users and society as a whole would benefit if the driver had fitted new brakes, the benefit being £150 (equal to the avoided loss of £200 minus the cost of the new brakes, £50). If the driver is made legally liable for the loss – that is, he is required to pay the victim compensation of £200 should an accident occur – then clearly he

29 *Yale Law Journal*, 1967, 70: 499–553.

30 G. Calabresi, *The Costs of Accidents: A Legal and Economic Analysis*, Yale University Press, New Haven, 1970. Calabresi's work was introduced to a British audience in P. S. Atiyah, *Accidents, Compensation and the Law*, Weidenfeld & Nicolson, London, 1970.

would have a strong incentive to fit the new brakes. A liability rule that shifts the loss whenever it would encourage careless drivers to fit new brakes makes the efficient solution the cheapest solution for the driver.

The distinctive quality of Calabresi's work was to show the power of simple economic principles to rationalise a whole body of law, and to develop a coherent normative basis for its reform.

Posner's efficiency analysis

The next two decades were the growth period of the law-and-economics movement, perhaps peaking in the mid-1980s in the USA.[31] Increasingly, North American legal scholars began to use economics to rationalise and appraise the law, and by the end of the 1980s the law-and-economics movement had firmly established itself as a respectable component of legal studies.

If one personality had to be chosen to represent this period, it would be Richard Posner, then of the University of Chicago Law School (now Chief Judge of the US Court of Appeals).[32] Although Posner's work remains controversial, there is no doubt that his contributions are both important and durable.

Posner demonstrated that simple economic concepts could be used to analyse all areas of law – contract, property, criminal, family, commercial, constitutional, administrative and procedural laws. His treatise, *Economic Analysis of Law*, first published in 1973 and now in its sixth edition, is a tour de force of subtle (and sometimes not so subtle) and detailed applications of economics to

31 W. M. Landes and R. A. Posner, 'The influence of economics of law: a quantitative study', *Journal of Law and Economics*, 1993, 36: 385–424.

32 R. A. Posner, *Economic Analysis of Law*, Little, Brown, Boston, MA, 1977 (6th edn, 2003).

law. Posner has shown that many legal doctrines and procedural rules could be given economic explanation and rationalisation. This type of economic analysis of law (which is discussed further in Chapter 4) attempts to explain the nature of legal doctrines using the concept of economic efficiency. While this approach is fraught with difficulties, Posner's work, beginning with his paper 'A theory of negligence',[33] and refined in an impressive sequence of articles and books, ushered in a new branch of economic analysis of law, one that the lawyer could use to discover the basis of the hotchpotch of doctrines that make up the common law.

Posner rose to prominence, even notoriety, and captured the imagination of a generation of scholars by going farther to advance the radical thesis that the fundamental logic of the common law was economic. He argued that judges unwittingly decided cases in a way that encouraged a more efficient allocation of resources. To the economist, this claim is remarkable for two reasons – judges typically ignore and occasionally reject economic arguments and, when they do employ economics, it is invariably incorrect. To lawyers the complete absence of any reference to economics in decided cases was enough to reject the claim outright. Yet Posner argued that they used, albeit unwittingly, an 'economic approach', and that economics could 'explain' legal doctrines even though these doctrines purported to have no explicit economic basis.

1980 to date

By the mid-1980s the economics of law was a firmly established feature of legal studies in North America. In the USA many of the

33 *Journal of Legal Studies*, 1972, 1: 28–96.

prominent scholars in the field (Posner, Bork, Easterbrook, Scalia and Breyer, and later Calabresi) were all 'elevated' to the bench under President Reagan's administration. In 1985 Professor (now Judge) Frank Easterbrook was able to claim that: 'The justices [of the US Supreme Court] are more sophisticated in economic reasoning, and they apply it in a more thoroughgoing way, than at any time in our history.'[34]

Economists were also becoming prominent in the area. Many, such as William Landes, Mitch Polinsky, Steven Shavell and George Priest, were appointed to law schools; law-and-economics programmes and courses sprang up in the top universities; and there was an active programme organised by Henry Manne teaching US lawyers and judges economics. Today most standard economics textbooks contain considerable analysis of law ranging from property rights and liability rules (Coase Theorem) to detailed analysis of contract and criminal laws.[35] This trend is also evident in legal texts and casebooks, which often integrate the economic perspective in the discussion of cases.[36]

There has also been a broadening out into different 'schools', such as the New Institutionalist Economics (NIE) most

34 F. Easterbrook, 'Foreword: The court and the economic system', *Harvard Law Review*, 1984, 98: 45.

35 In March 1993 the *Journal of Economic Literature* of the American Economics Association added 'Law and Economics' as a separate classification, formally recognising it as a distinct field of research.

36 H. G. Beale, W. D. Bishop and M. P. Furmston, *Casebook on Contract*, 4th edn, Butterworths, London, 2001; D. Harris, D. Campbell and R. Halson, *Remedies in Contract and Tort*, 2nd edn, Cambridge University Press, Cambridge, 2002; A. Clarke and P. Kohler, *Property Law – Commentary and Materials*, Cambridge University Press, Cambridge, 2005; B. Cheffins, *Company Law – Theory, Structure and Operation*, Clarendon Press, Oxford, 1997.