LAW AND ECONOMICS

Type of economics: General economics
Field of study: Economic theory

The relationship between law and economics involves the application of the methods of microeconomic analysis to an explanation of legal institutions. Concepts such as efficiency and wealth maximization are used to analyze the behavior of legal actors, such as judges, legislators, plaintiffs, and potential criminals.

Principal terms

EFFICIENCY: the outcome that is achieved when marginal cost equals marginal benefits; efficiency can be measured in the terms of Pareto optimality and/or wealth maximization

MARGINAL COST OR BENEFIT: the incremental cost or benefit of pursuing an activity, such as producing or consuming one more unit

NEGLIGENCE: the failure to act in accordance with certain minimal standards of care

PARETO OPTIMALITY: a situation in which no Pareto superior exchanges are possible

PARETO SUPERIORITY: a situation in which one party is better off and no one is worse off

STRICT LIABILITY: a system in which people who cause accidents are liable for damages regardless of their level of care in acting

TORT: a wrongful act, other than a breach of contract, for which a civil lawsuit can be brought

Overview

The relationship between law and economics encompasses a number of different analytic strategies for understanding and evaluating the behavior of the actors who operate within legal institutions. The overriding assumption is that rational behavior, and hence the rationality of specific legal policies and institutions, can be captured in economic terms. The field of law and economics seeks, therefore, to provide an explanatory, as well as a normative, theoretical structure for explicating legal behavior. The field is truly interdisciplinary, with jurisprudents and philosophers, not simply professional economists, pooling their talents, insights, and methodological approaches.

It is necessary to distinguish the positive theories of law and economics from the normative theories. Positive theories seek to describe the behavior of legal actors. Theorists operating within this framework argue that legal behavior, at least within certain legal institutions, is best explained in economic terms. Normative theories argue that legal behavior should focus on desired economic goals. This simple distinction allows a number of theoretical permutations. Thus, one can argue that legal institutions are described and explained by their progress toward the economic goal of efficiency, and that legal actors should act to further this economic norm. Alternatively, one can insist that legal behavior is not best explained in economic terms and the actors should not necessarily seek economic goals in their legal behavior. Compromise positions argue that legal behavior often furthers wealth maximization but that this goal should not be the predominant normative end of legal institutions. Inversely, such positions argue that an economic hypothesis does not presently describe or explain legal behavior but that efficiency should be the goal of legal behavior and legal institutions. Scholars who work this field do not always stipulate whether their arguments are intended to support positive or normative hypotheses.

The central economic concept that underlies the entire field of law and economics is that of efficiency. Legal analysts who endorse economic approaches believe that legal behavior can be interpreted as an attempt to achieve the efficient allocation of scarce resources. Most economists think of efficiency in terms of Pareto superiority and optimality—transactions that make one party better off, and none worse off. Economic scholars of law typically employ a variant of the Pareto criterion, the so-called Kaldor-Hicks or potential Pareto superiority sense of efficiency. In this sense, it does not matter if one party is made worse off, but rather whether this party could have been fully compensated so that he or she was no worse off, while the other party is made to be better off. Because these compensating transactions are often hypothetical, this sense of efficiency begins to approximate the simple criterion of total wealth maximization, subject only to some very loose constraints. Indeed, many scholars working in this field use the criterion of wealth maximization as roughly equivalent to the concept of efficiency.

It is important to note how counterintuitive the relationship between law and economics hypotheses may seem. Traditional accounts of the law are typically articulated in the language of moral philosophy—justice is the concept most often identified as the ideal for legal behavior. Alternatively, legal systems occasionally have been addressed by the kind of purely behavioral hypotheses that are typically offered by sociologists. Economic analyses of law offer a radical change in perspective that is the source of both the major attractions of the perspective as well as its most strident criticisms. Many people believe that this strikingly new method promises original insight into the institution of law. It allows the study of law to remain "realistic" by focusing on the actual behavior of legal actors, while, at the same time, not dismissing the language of legal opinions as mere rhetoric that is designed to mask the personal and political predilections of individual judges. This field proves controversial, however, because many find it difficult to see why the single-minded pursuit of economic efficiency should be the goal of as ancient and important an institution as law. An important critic, Ronald Dworkin, articulates the worry by asking "Is wealth a value?"

Applications

The field of law and economics is best seen as a methodological approach to the study of law. Consequently, the method has been the source of a number of different concrete hypotheses, many of which have proven exceedingly controversial, even among scholars equally committed to the overall perspective. This section focuses on a few specific examples of how law and economics can provide insight into legal institutions, beginning with a brief discussion of the issues of criminal law and the law of contracts and concluding with a more detailed illustration from the law of torts.

Both the behavior of potential criminals and of society as a whole, which seeks to deter criminal behavior, can be modeled in economic terms. If potential criminal sanctions are seen as costs, then criminal behavior can be directly influenced (that is, deterred) by society's setting of these costs at an appropriate level. Decisions by potential criminals, therefore, can be explained in economic terms—measuring the risk of being caught, being convicted, and receiving the typical punishment, against the gains from the illegal act. Society is also faced with allocative questions. There are clear costs associated with maintaining an effective criminal justice system. An economic theory of the criminal justice system would seek to establish the efficient levels of administrative costs for the police, courts, and prisons. Society must also determine the efficient levels of criminal penalties. The ideal overall effect is to maximize society's net wealth by deterring the optimal level of potential crime.

Contract law is sometimes characterized as the attempt by the courts to articulate fully specified contracts (contracts that cover every eventuality) after the fact. The fully specified contract is both impossible and inefficient. The costs of articulating every eventuality would clearly overwhelm any economic gains from fully specified contracts. Thus, the function of contract law is to resolve misspecified contracts in the terms that the contracting parties would have agreed to, had they been able to foresee the existing circumstance. Fully specified contracts would always include provisions for efficient breach—situations in which it is in one party's interest to breach the contract and the other party is indifferent. Economic theories of contract seek to explain contract law, and in particular possible judicial remedies, in terms that encourage efficient breach and deter inefficient breach.

Tort law is a relatively new area of the common law in which the rules made by judges take on the force of law through the institution of legal precedent. It has evolved from a system of strict liability—if one person's behavior causes others to suffer losses, then he or she is responsible for compensating them—to a system of fault or negligence—someone is only liable if his or her level of care falls below some prescribed level. Many have argued that this rough historical progression can be explained in economic terms.

If one assumes that one goal of torts is the deterrence of accidents, the fault system appears attractive. Society does not really want to deter all accidents—such a state of affairs would simply be too expensive, and hence, inefficient. Economic scholars of law have suggested that the common law identifies the standard of negligence or fault at precisely that point at which the marginal gain from preventing accidents, such as avoiding accident compensation by driving more slowly, equals the marginal cost, such as the lost time spent on the road. It is perhaps surprising that under a system of strict liability, as well as under negligence, rational actors will, in theory, discover the appropriate level of care for preventing accidents and adjust their behavior accordingly. Under the fault system, drivers will clearly have a disincentive to drive too fast, as by keeping their speed below the optimal level they can escape accident liability completely. Drivers are always liable under strict liability, but they will still drive at the optimal speed, because by definition, this is the speed at which their personal utility is maximized. Thus, either system is equally efficient in deterring accidents by adjusting the behavior of drivers.

In this example, the problem may be the behavior of pedestrians. Presumably, their behavior and level of care will also affect the level of accidents. Plausibly, it can be argued that, under strict liability, they have no incentive to exhibit optimal care. Full compensation for the economist means that pedestrians are indifferent between not being involved in accidents and being involved but compensated. Thus, they could be expected to maximize their personal utility by excessively rapid walking (or running as fast as they can), but their incentive is not optimal because there would be no cost for their careless behavior. Under the fault system, however, they would have a large amount of incentive to exhibit optimal care. They would assume that rational drivers would exhibit appropriate care in order to avoid liability. Thus, in most accidents, pedestrians would bear the accident costs. This clearly would act as a deterrent to careless walking.

The above illustration is far from the last word in the economics of torts. The system of strict liability can be, and has been, modified to take account of this kind of problem. One can employ the defense of contributory negligence in a system of strict liability. In this case, accident compensation always lies with the person who caused the accident, unless the victim was negligent, in which case, total responsibility lies with the victim. In such a system, drivers have the appropriate incentive to drive with optimal care for the reason stated above, and pedestrians have an incentive to walk with optimal care, as they do not want to forfeit their claim to damages. One potentially surprising result in the literature of law and economics is the proof that the fault system and a system of strict liability with a defense of contributory negligence are equally efficient in deterring accidents.

Other allocative questions may come into play, of course, in deciding between the two systems. Strict liability seems to save in information costs, as courts need not determine whether drivers were negligent or not. At the same time, however, the fault system seems to save administrative costs, as only those accidents in which the victim believes that he or she can show negligence will be litigated. There remains much controversy among economic legal scholars as to which system is more efficient in the terms of minimizing information and administrative costs.

Context

One can find hints of the law and economics approach in legal, political, and philosophical discussions that date back to Adam Smith (1723-1790) and Jeremy

Bentham (1748-1832). It was not until the very latter part of the nineteenth century, however, that a discussion that approaches a true economic theory of law can be found. Many of the points that are raised in the classic book *The Common Law* (1881), by Oliver Wendell Holmes (1841-1935), exhibit a subtle understanding of the economic impact of legal policies. In the 1920's and 1930's, legal realists often connected economic concerns with judicial decisions and the content of legal opinions. Finally, Judge Learned Hand's famous 1947 opinion in *United States v. Carroll Towing Co.* explicitly appealed to economic considerations in determining the level of negligence. Nevertheless, the field of law and economics as a distinctly recognizable academic field did not begin until the early 1960's, primarily through the work of two scholars, Ronald H. Coase and Guido Calabresi.

Coase, in a truly seminal article, demonstrated that, if transaction costs were assumed to be zero, the specific allocation of legal rights and responsibilities would have no effect on society's net wealth. This result, called Coase's theorem, is foundational to the entire field of law and economics. Calabresi's contribution was to apply explicitly microeconomic methods to the study of accident law, advancing the normative hypothesis that torts should assign responsibility to the party that could have most cheaply avoided the accident. Coase's article and Calabresi's first article both appeared in 1961, and, although many scholars discussed and debated both theories throughout the decade, it was not until the early 1970's that scholars began to employ widely the economic methodology to the study of law. At that time, the academic specialty of law and economics came to be recognized.

The field continues to thrive, with much theoretic work appearing regularly. More and more attention is now being paid to empirical studies which seek to confirm or disconfirm specific theoretical hypotheses. Abstract intellectual approaches to the law tend to wax and wane in popularity. Law and economics is clearly one of the favored contemporary approaches and promises to remain so for the foreseeable future. Despite the surprising and controversial nature of the law and economics approach, it has clearly transformed the scholarly investigation of law. In the United States, every major law school routinely offers courses dealing with the subject and prestigious appointments to the federal bench have gone to scholars who have helped to create the approach. One can predict with much confidence that, with a new generation of academic lawyers, as well as economists, an explosion of scholarship in this field can be expected, both at a theoretical and at an empirical level.

Bibliography

Calabresi, Guido. *The Costs of Accidents: A Legal and Economic Analysis.* New Haven, Conn.: Yale University Press, 1970. The first book-length attempt to apply economic methods to the study of a specific area of law, it is one of the "classics" in the law and economics literature. Calabresi is an academic lawyer speaking primarily to other academics. Nevertheless, the book is engaging and accessible.

Coleman, Jules. *Markets, Morals, and the Law.* Cambridge, England: Cambridge University Press, 1988. A collection of papers by a professional philosopher who is one of the most acute expositors and critics of law and economics. Coleman defends a moral analysis of torts. Although some of the articles are quite technical, Coleman is an exceedingly clear writer with good pedagogic instincts.

Cooter, Robert, and Thomas Ulen. *Law and Economics.* Glenview, Ill.: Scott, Foresman, 1988. This textbook, an important collaborative effort by a leading academic lawyer and a professional economist, provides a very thorough overview of a number of areas of the law that have been examined through economic means. Intended for advanced undergraduate students but presupposes no previous work in either law or economics.

Kuperberg, Mark, and Charles Beitz, eds. *Law, Economics, and Philosophy: A Critical Introduction with Applications to the Law of Torts.* Totowa, N.J.: Rowman & Allanheld, 1983. This anthology of professional papers contains the work of some of the most prominent scholars working in this area, as well as the thoughts of some of its most important critics. The papers are all aimed at a professional scholarly audience, but most should be accessible to nonexperts. The collection includes one particularly important paper, Ronald H. Coase's "The Problem of Social Cost."

Landis, William M., and Richard A. Posner. *The Economic Structure of Tort Law.* Cambridge, Mass.: Harvard University Press, 1987. Posner is one of the early and most influential proponents of law and economics; he has collaborated with Landis on a number of previous occasions. This book constitutes an extensive examination of tort law and a spirited defense of the positive theory of law and economics.

Polinsky, A. Mitchell. *An Introduction to Law and Economics.* Boston: Little, Brown, 1983. A strikingly successful short introduction to the field. Polinsky is trained in both economics and the law, and he is an excellent pedagogue. Contains numerous quantitative examples, but presupposes no mathematical training beyond simple arithmetic. One particularly attractive feature of the book is its inclusion of the effects of insurance on the economic analysis of torts.

Jeffery L. Johnson

Cross-References

Coase's Theorem, 301; Contracts, 403; Efficiency, 653; Externalities, 780; Pareto Economics, 1686.