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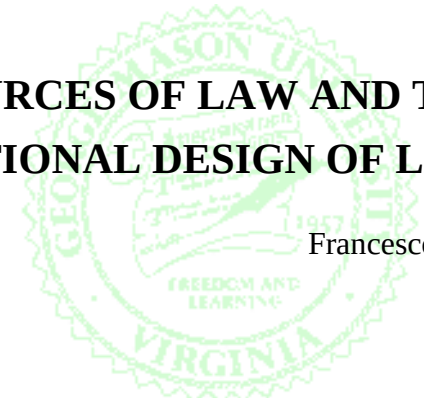

SOURCES OF LAW AND THE
INSTITUTIONAL DESIGN OF LAWMAKING

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Francesco Parisi

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Francesco Parisi[1]

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ABSTRACT: This paper considers the relative advantages and the respective limits of three main sources of law, namely, (a) legislation; (b) judge-made law; and (c) customary law. The traditional presentation of sources of law is revisited considering the important issue of institutional design of lawmaking through the lens of public choice theory. This functionalist approach to legal analysis sheds new light on the process of law formation emphasizing various criteria of evaluation, which include: (i) the minimization of agency problems; (ii) the minimization of direct and external rulemaking costs; and (iii) the stability and transitivity of collective outcomes.

According to a fundamental principle of constitutional design, powers should be allocated to the branch and level of government or society that can best exercise them. This principle can be applied to the question of lawmaking in order to select sources of law that will exploit the comparative advantage of different legal and social institutions in the production of legal rules.

The traditional conception of these three sources of law is enriched by a consideration of the important issue of institutional design of lawmaking through the lens of public choice theory.

I. Three Goals in the Institutional Design of Lawmaking

I consider three main criteria for evaluating the relative advantages of alternative sources of law, focusing on the political economy of production of ordinary (i.e., non-Constitutional in nature) law. These criteria are: minimization of agency problems; minimization of rulemaking costs; and the stability and transitivity of collective outcomes.

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[1]Professor of Law & Co-Director, J.M. Buchanan Center for Political Economy, Program in Economics and the Law, George Mason University (USA).

A. Minimization of Agency Problems

First, the mechanisms for law creation should be able to reflect the underlying preferences of the individuals subject to the law. For the case of political processes of law formation, this requires the choice of collective decision making procedures that will promote the alignment of the incentives of political representatives and the incentives of the represented citizens. In the presence of perfect incentive alignment, agency problems in political representation will disappear.

Likewise, in an ideal world judge-made law should approximate the rules that private parties would have chosen if engaging in an *ex ante* choice of applicable law. This claim, known as the efficiency of the common law hypothesis, constitutes an important premise of the law and economics movement. According to this hypothesis, the common law (i.e., judge-made law) is the result of an effort—conscious or not—to induce efficient outcomes. The same proponents of this hypothesis suggests that common law rules enjoy a comparative advantage over legislation in the creation of efficient legal rules because of the evolutionary selection of common law rules induced by adversarial adjudication.

The case of customary law is quite different from those of the other sources of law. Customary law avoids the interface of third party decision makers (such as legislators and judges) and is directly derived from the observation of the behavioral choices of individuals in society. In a customary law setting, the group of lawmakers coincides with the subjects of the law and agency problems are generally absent from such process of law formation. In the following discussion, we will consider a different group of problems that affect the process of customary law formation.

In all the above cases, the institutional design of lawmaking should induce incentive alignment in order to minimize the extent of agency problems, with a minimization of rent seeking and a resulting optimal supply of public goods.

B. Minimization of Rulemaking Costs

The second criterion for evaluating alternative sources of law is that of cost minimization of collective decision-making. According to this criterion, the mechanisms for law creation should be chosen in

order to minimize the transaction costs of collective decision making and political bargaining.

This cost minimization problem involves the evaluation of two different costs: (i) direct costs of decision making, such as the costs of reaching a majoritarian consensus in a political context, or the cost of litigation or adjudication in a judicial context; (ii) indirect or external costs, such as the cost imposed on a minority group by the rules chosen by a majority coalition. Different levels of transaction costs of types (i) and (ii) are inherent in the different processes of law formation.

1. Direct Costs of Lawmaking. In a legislative process, individual preferences are captured by the collective decision making process through the imperfect interface of political representation. Bargaining among political representatives is costly, due to the strategic behavior of large number bargaining (i.e., free riding, hold ups, and other collective action problems) and the absence of legal enforcement mechanisms for political bargains. In this dimension, lawmaking through politics is likely to impose the highest level of transaction costs among the alternative sources of law that we consider.

Transaction and information costs are also present in the case of judge- made law. The process of judicial creation of legal rules faces the obvious constraint given by the costly access to information regarding alternative legal rules. If we analogize the lawmaking process to a production process in the marketplace, the common law may indeed appear as quite an inefficient production process. The common law process, when shifting some of the law making functions to the judiciary, entrusts courts with the task of conceiving and refining legal rules while adjudicating specific cases.

From a production point of view, such process foregoes the economies of scale and scope that might be exploited by a specialized legislative process. On the other hand, the common law process, by relying on the adversarial efforts of the parties, utilizes information available to the parties. Parties have direct information on the costs and benefits of alternative rules and courts may be regarded as having an informational advantage over central legislative bodies, given the

opportunity of judges to infer the litigants' preferences from the choices they make during the case.

Courts have a further informational advantage in observing the revealed preference of the parties with respect to applicable law. Modern legal systems generally provide a set of default rules that apply if the parties fail to choose alternative provisions to govern their relationship. When parties opt out of the default rules (through ex ante choice of differing provisions or ex ante choice of law), they reveal their preferences over alternative legal rules. If courts observe a large number of parties routinely opting out of the default rules, it becomes evident that such rules have failed their cost-minimization task under the circumstances and do not approximate the will of the majority of the contracting parties. In these cases, courts would have a comparative informational advantage over legislators in designing and revising default legal rules.

For the case of customary law, we should distinguish two distinct costs: (a) the cost of decentralized creation of a customary legal rule; and (b) the cost of judicial finding of an existing rule of customary law.

The costs of customary law creation are relatively minimal. Most rules of customary law are derived from the observation of widespread practice followed by individuals in society. In this context, customary rules are a costless byproduct of the economic and social interactions of individuals in society. Such practices are not being carried out with the objective of giving birth to binding rules of customary law and the legal recognition of such practices as binding customs adds no cost to the activities involved.

The cost for courts to identify a rule of customary law may, however, be considerable. Customs are intangible sources of law and their content does not enjoy any objective articulation in written law. The identification of custom thus requires knowledge of past practice and investigation of the beliefs shared by those who engaged in the practice: a process that can be costly and difficult to carry out.

A point of advantage of customary sources of law is related to the fact that custom is formed through the independent action of individuals in society, without the need for their express agreement to the emerging rule. Since most rules of custom require a very high level of participation without yet necessitating a unanimous

consensus, hold up problems and other transaction-associated costs are generally avoided in the formation of customary legal rules. No single individual in society can prevent the emergence and recognition of a general custom.

2. External Costs of Lawmaking. The various sources of law also have different levels of external costs. As public choice theory has shown, in the case of political decision-making, direct costs and external costs of lawmaking are negatively correlated (Buchanan and Tullock, 1962). The tradeoff between direct and external costs is easily illustrated by the consideration of the two limit cases of unanimity and dictatorship in a voting context. If deliberations require a unanimity vote, the risk of external costs disappears, since unanimity gives every voter a veto power against undesired proposals. Transaction costs are instead very high under a unanimity rule. In the opposite case of dictatorship, the risk of external costs is much higher, since a dictator can single-handedly impose costs on all other individuals. Conversely, the direct costs of lawmaking are lowest under dictatorship, given that no consensus and political bargaining is necessary under a dictatorial decision rule.

Analogous tradeoffs between direct and external costs exist for sources of law other than legislation, but the content and interpretation of such costs differ substantially in each case. Thus, for example, rules of customary law require a very high level of participation and consensus. This reduces the risk of external costs imposed on unwilling minorities, but, as a result of such high threshold of required participation, customary laws are relatively slow in their emergence and evolution.

In evaluating the various sources of law, it is necessary to give careful consideration to the different performance of alternative lawmaking processes from the vantage point of this criterion of cost minimization.

C. Stability and Transitivity of Collective Outcomes

The third problem of institutional design is to minimize the cost of instability and ensure rational and transitive collective choices. As it has been observed in the literature (e.g., Cooter, 2000; Stearns,

1994; and Parisi, 1998), when political cooperation fails and the lawmaking mechanisms do not generate Condorcet winners, several legal institutions and doctrines come to the rescue to minimize instability and select among cyclical alternatives. In particular, Cooter (2000) explains how democratic constitutions pursue these goals of stability by separating powers among the branches of government, by guaranteeing individual rights, and creating a framework of competition for political office. Parisi (1998) considers the role of logrolling as an instrument of stability in a legislative setting. With reference to judge-made law, Stearns (1994) considers the role of standing doctrines and stare decisis as evolved institutions aimed at reducing instability in the absence of a Condorcet majority consensus. In the different setting of customary law, Parisi (1997a and 1997b) discusses the process of formation and evolution of customary law, unveiling the ability of customary law to generate stable rules in different game-theoretic situations.

II. Law Through Politics: The Political Economy of Legislation

Comparative differences in legal systems often reflect different ideologies and conceptions of political economy of lawmaking. In recent years, all countries of the modern world have been giving written statutes increasingly greater importance among the sources of law. The supremacy of written law over other sources of legal order is not, however, a universal characteristic of all modern legal systems.[2]

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[2] Comparative legal scholars usually distinguish between civil law and common law systems. The distinction is based on a dichotomous conception of legal traditions. Systems of the civil law tradition give greater weight to written and statutory sources of law. Generally speaking, these systems are historically derived from a legal tradition that recognized the authority of a comprehensive body of written law (e.g., the Roman Corpus Juris) and were not relying on the casuistic evolution of case-by-case decision making in the absence of a coherent skeleton of codified law. This dichotomous distinction, while useful as a preliminary classificatory tool, should not be overestimated. During the last several decades, legal systems of the world have converged toward a middle ground. In the civil law tradition, the dogmas of supremacy of legislation over case-law have gradually given way to a more balanced conception of sources of law, where statutes and case-law more or less happily coexist with one another. Likewise, in the common law tradition, the proliferation of legislative intervention has gradually corroded the traditional dominance of judge-made sources.

A. Lawmaking and Political Representation

During the nineteenth century, the enlightened conception of democratic governance and the renewed trust in political decision-making fostered an increased importance of statutory law. Ideals of democratic legislation gradually replaced the historic conception of statutory law as a written articulation of laws of a higher and older origin. Laws were not the mere expression of preexisting natural or fundamental rights, but rather they were the primary source, if not the sole origin, of individual rights. Rights were derived from laws, rather than laws being derived for the protection of individual rights. Legislative bodies were making (i.e., creating) law as opposed to finding (i.e., recognizing) preexisting legal norms. With the exception of some minimal Constitutional constraints on law making, national parliaments and congresses acted as sovereign lawmakers. Such unbounded legislative powers were justified by the alleged function of legislative organs as faithful agents and political representatives of the people.

The unfolding of history has, however, revealed the true face of democratic decision-making and the limits of mechanisms of political representation in lawmaking. There are two theoretically distinct problems that affect the mechanisms of political representation. These problems have become the respective focus of several important contributions in the public choice and social choice literature. Within the public choice tradition, we learn that political representatives are agents of the individuals they represent. Such political representation is often affected by pervasive agency problems. The correction of these problems requires the choice of collective decision making procedures that promotes the alignment of the incentives of political representatives with the incentives of the represented citizens, or else an effective monitoring and accountability of political agents. If incentives are effectively aligned, agency problems of this type do not affect political representation. Much of the public choice and the constitutional design literature addresses these fundamental problems.

The second problem emerges even in the absence of agency problems in representation. This problem is one of selection of appropriate criteria for aggregating individual preferences. If the interests of politicians align with the interests of the people whom

they represent, politics can be viewed as a framework for bargaining among political agents of the various factions in society. The question is whether political bargaining can successfully yield a consensus among the various political factions, such that political outcomes can be legitimately and unambiguously identified with the "will of the people."

As the social choice literature has often pointed out, even if we contemplate a world of perfect incentive alignment between political representatives and the represented citizens (i.e., even if we assume away agency problems in political representation), there is no assurance that the mechanisms of law creation are responsive to the underlying preferences of individuals in society.

B. One Man, One Vote and the Politics-like-Markets Metaphor

The heart of Arrow's theorem states that there are no non-dictatorial rules or procedures for collective decision-making that reflect the combined preferences of voters to a consistent collective outcome (Arrow, 1951). The implications of Arrow's theorem concern the existence of cyclical majorities which are capable of repealing any resolution that has been adopted previously. Parisi (1998) suggests that, if all voters are allowed to enter into binding agreements over the policy outcome to be adopted by the majority coalition, collective preferences in a multi-dimensional policy space will be transitive as long as individual preferences are single-peaked.[3]

The inability of the democratic process to capture the intensity of the voters' preferences is a by-product of the generally espoused principle that every individual is entitled to one–and only one–vote. The "one man, one vote" rule is further explained by the fact that

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[3] This intuition runs contrary to the common thought in public and social choice theory (See, e.g., Bernholz, 1973; N.R. Miller, 1977; and Th. Schwartz, 1977). Most of the literature on the stability implications of log-rolling considers log-rolling in the context of bargaining for the formation of coalitions where side-payments are only instruments for entering the majority coalition, and no side-payments are made by those who are not part of the majority. The political reality is often different from that contemplated by these scholars. Bargaining is certainly permitted even between minority and majority voters, with exchanges taking place among all coalitions. As shown by Parisi (1998), if we allow for a broader role for bargaining and side-payments and contemplate binding and enforceable political bargains across different coalitions, the results would be quite different.

individual voters do not face the opportunity cost of casting their vote. Whether their preference is strong or weak, voters will cast their vote in favor of their favored option. Even if voting were specifically designed to allow voters to indicate the intensity of voters' preferences, the voting ballot could not possibly capture such intensity. Absent a mechanism to extract the true intensity of their preferences, individual voters would tend to overstate their preference in order to maximize the impact of their votes.

Democracy gives equal weight to all votes when they are counted, regardless of how strongly the voters feel about the issue. In this way, numerically equal groups have equal political say in the process. However, if the distribution of sentiments on an issue is not symmetrical, and the minority holds strong preferences, the outcome would be inefficient. By introducing the possibility of bargaining and vote-trading in the process, the intensity of preferences will be reflected in the decision-making process. With bargaining and side-payments, the "one man, one vote" rule would provide the initial entitlement for each voter-trader. The exchange mechanism would then reveal the relative strength of individual preferences.[4] Political bargaining may provide a solution to the intensity problem, and at the same time correct for the cyclicality problem. Legislators sharing similar information on their respective prospects will have an opportunity to bargain under conditions of symmetric information, trading votes for issues on which they hold weak preferences in exchange for votes on issues which have more value for them. Economic theory teaches us that bargaining between politicians will continue until the marginal utility of gaining one vote on a certain issue equals the marginal cost of giving up one vote for another issue. Parisi (1998) suggests that both stability and efficiency will be obtained through bargaining, as long as the exchanges are enforceable and relatively costless to carry out. We know, however, that in real politics, bargaining is afflicted by a special problem that is usually absent in private contracts (Cooter, 2000). Political agents are limited to the extent which they can enter into enforceable political bargains. For example, coalitions agreements are only good until a new

[4] From an efficiency perspective, in fact, weight should be given to intensive preferences.

coalition is formed. Likewise, there is no way to bind future voting decisions in a log-rolling context, or to constrain the choices of future office-holders.

C. Limits of the Politics-Like-Markets Metaphors

In real politics, legislative and political bodies seldom work like markets. Cooter (2000) points out three main challenges to the politics-like-market analogy. The first reason why political markets do not work like ordinary markets is that the value of a legislator's vote often depends upon how the other legislators vote. There are pervasive externalities and resulting free riding incentives in political action. The second reason is that real life politics has too many political actors for each one to bargain with everyone else. Unlike the atomistic marketplace of traditional economics, bilateral negotiations would be prohibitively expensive in real life politics. Third, Cooter points out the diffuse hostility to a rationalization of politics as a market for consensus. Ordinary citizens with little information about legislative bargains and would resist any institutionalization of political bargaining, objecting to their representatives participating in open log-rolling.

Indeed, a full analysis of the politics-like-market analogy cannot be accomplished in a vacuum, but rather must be exposed to the reality of democratic politics. The following corrollaries are discussed by Parisi (1998) and are illustrative in this regard: (1) issue bundling; (2) free riding and bargaining failures; and (3) agency problems and the political dilemma.

1. Issue Bundling. In the real world of politics, transaction costs are present. As a way to minimize the effect of transaction costs, policy "packages" are traded and voted upon in the usual course of dealing. Political deals are indeed characterized by a bundling of different issues. Congressional voting normally requires a binomial vote on legislation, supplying a bundle of bargained-for provisions. House and Senate rules do not prevent amendments that are unrelated to the subject matter of the bill at issue. From an efficiency perspective, bundling–just like tying in a commodity market–may generate suboptimal outcomes. In order for a vote exchange process

to work at its best, all dimensions of the policy space should be the potential object of bargaining and trade. Bundling reduces the dimensions of the bargaining space. At the limit, all policy dimensions may collapse down to a two-dimensional policy space, limiting the domain of the optimization process.

In an ideal world with no transaction costs, in order to maximize the beneficial functioning of the political market, no bundling should exist. In the real world with positive transaction costs, a positive amount of bundling is to be expected and is part of the global optimization process. Elhauge (1991, p. 31) has noted that where there is issue bundling, "diffuse interests can be systematically under-represented even if voters face no collective action problem." But the market will adjust to reach the optimal tradeoffs between the savings on transaction costs and the inefficiencies of tying.

2. Free Riding and Bargaining Failures. An important assumption of the Coase theorem is the absence of transaction costs. A costless transaction requires the absence of strategic behavior in the bargaining process. This condition is highly problematic in the context of multi-party voting. The opportunity for individual strategic behavior is elevated where two polar groups seek compromise. In the real-world market for votes, the term "triangulation" has been to describe the result of efforts to legislate in the middle ground between ideological extremes, where vote-trading trans-action costs are high (Broder (1997), attributing the "triangulation" concept to former Clinton-advisor Dick Morris).

All cyclicality problems require the presence of at least three voters. Bargaining among three voters in a two dimensional space is highly sensitive to free riding and other forms of strategic preference revelation. If we think of this triangular situation in a spatial voting setting, we can realize that any movement in the policy space will generate benefits or losses for at least two parties. In the great majority of cases, all three parties will be affected by a potential policy change. Under such conditions, any bargaining carried out by one voter has the potential of creating side benefits for another voter. Any policy change "purchased" by one voter is potentially a free good (or a free bad) for another voter. In a three-party bargaining, voters are thus faced with a collective action problem. The problem is

exacerbated by an increase in the number of voters. In a multi-voter setting, strategic behavior may indeed plague the bargaining process.

The collective action problem described above is not different from any other free riding problem in a Coasian setting. Olson (1997) has discussed the collective action problem in the context of a Coasian bargaining, questioning the practical validity of the Coasian proposition in a multi-party context. If the object of one individual's bargaining generates a benefit to other individuals who are not involved in the bargain, what is obtained through the bargaining of one individual creates a positive externality to other individuals. Thus the incentives to undertake the bargaining may be seriously undermined. Every individual wishes to be the free rider, having somebody else pay the price of the common good. Thus, similar to any public good situation, there will be a sub-optimal level of bargaining for the common interest.

3. Agency Problems and the Political Dilemma. The analysis of the hypothetical market for votes considered in this article takes the will of the voters as a given. Further analysis should consider the effect of agency problems in the bargaining mechanism. In the real world of politics, most collective decisions are carried out by political representatives, who undertake collective decisions as agents of the represented individuals. Political representation is often undermined by serious agency problems. Public choice theory provides ample analysis of the factors of such incentive misalignment, including (a) rational abstention; (b) rational ignorance; and (c) regulatory capture and resulting special interest legislation. Such discrepancies are most visible when an agency problem in political representation occurs at the margin of a crucial vote.

If bargaining is carried out in the absence of agency problems, the bargaining result maximizes the voters' utility, as illustrated above. But where the bargaining is carried out by interested representatives, the opportunity is present for departures from the optimality outcome described above.

In general terms, if market mechanisms are allowed to operate in political contexts, the collective decision-making mechanism is lubricated. In the absence of representation failures, the collective outcome will approximate the allocative outcome of a competitive

market. If bargaining is carried out by agents whose underlying incentives differ from those of their principals, the market mechanism may generate greater discrepancies between the ideal and the real political outcomes, including the fact that agents may be induced to abandon their principals' core values.

D. Instability and the Cost of Legislation

The absence of legal enforcement mechanisms in political contracts increases transaction costs and often represents an unsurmountable obstacle to political cooperation. According to Cooter (2000), the institutional design of lawmaking should promote institutional arrangements that minimize the transaction costs of political bargaining.

With respect to legislation as a source of law, the previous sections have shown that the politics-like-markets analogues risk overlooking the difficulties of correcting political failures through political bargaining. The existence of effective exchange mechanisms within politics accentuates the features of the underlying political system. In a world of good politics, it allows for better outcomes. In a world of political failures, it may exacerbate the existing problems.

In a world where political bargaining exists, however, the existence of enforcement mechanisms within politics will promote stability and reduce costly intransitivity of collective outcomes.

As discussed above, stability cannot be used as a proxy for efficiency. It is indeed well-known in the social and public choice literature that a "Condorcet winner" can at times be inefficient, but at least it can always be trusted to satisfy the preferences of the majority of voting individuals. Absent mechanisms to induce voters to reveal the true intensity of their preferences, democratic legislative systems cannot improve on Condorcet winners and should maintain rules that allow such alternatives to prevail when they exist.

If Condorcet winners do not exist, the method and sequence of voting (e.g., agenda setting) determine the political outcome. In these cases, as Cooter (2000) aptly puts it, "democratic politics becomes a contest, not to satisfy the preferences of a unique majority, but to determine which majority's preferences will be satisfied." In these situations, institutions should be designed in order to minimize the

welfare costs of voting intransitivity and instability. The existence of enforceable contractual mechanisms for political exchange may be a valuable instrument of stability.

These results confirm Buchanan and Tullock's (1962, p. 153) important observation that "with all side payments prohibited, there is no assurance that collective action will be taken in the most productive way." Likewise, they provide a conjectural solution to Tullock's (1981) puzzle as to why there is so much stability in the political process.

III. Common Law and the Economics of Judicial Lawmaking

Judge-made law and doctrines of stare decisis have varying degrees of importance in the various legal systems of the world. There is a substantial historical difference between the role played by precedents in the common law and civil law traditions, reflecting fundamentally different views as to the nature and source of law-making. Whereas, under civil law, legislation and custom are considered the primary sources of law, the common law emphasizes court decision-making as a principal source of law.[5]

A. Separation of Powers and the Independent Judiciary

With the gradual expansion of statutory law, the recognition of precedents as sources of law was no longer a practical necessity. In this setting, contemporary legal systems have developed a variety of doctrines to determine the effective role of judicial decisions in the presence of legislation and to guarantee an effective separation between these two branches of government. Principles of separation of powers provide the constitutional foundations for balancing the institutional roles played by courts and legislators. Indeed, one key

[5] Historically, the common law and civilian approach to judicial precedent share a foundation in customary law. In spite of previously held beliefs to the contrary, scholars have established that it was not until the mid-19th century that the Common law rule of precedent developed into a formal rule of stare decisis. As a general trend, common law jurisdictions are bound by a single court decision, whereas some civilian and mixed jurisdictions only require a continuous line of precedents before recognizing a rule of jurisprudence constante, which courts will follow as an authoritative secondary source of law.

feature of most constitutional systems of the Western legal tradition is the principle of separation of powers, with particular importance placed on an independent judiciary to ensure the fair adjudication of law. The principle of separation of powers implies that, unlike the legislative and executive branches, most judges are (or should be) systematically shielded from political or economic influence.

As a matter of institutional design, the independence of judges can be achieved by either turning the judiciary into a bureaucracy-type institution, where judges are selected and promoted according to pre-established standards of performance on the bench, or through political appointment with life-tenure, with the consequent elimination of any ties with the appointing political body (Cooter, 2000). The first approach is generally followed by most civil law jurisdictions, while the second approach finds its typical incarnation in the federal judiciary of the United States.

Landes and Posner (1975) examine the effect of the independent judiciary on lobbying, the de jure system of interest group purchase of legislative policy. Economic analysis of the role of the courts shows how an independent judiciary can make viable a governmental process that emphasizes interest group participation in policy formation. By enforcing laws validly passed, even in a previous legislative session, the judiciary ensures integrity in the constitutional process by imposing prohibitive costs on public interest purchase of judicial decisions.

Landes and Posner work from the perspective of interest group analysis, pointing out that interest groups will not purchase policy programs if they cannot assume that desired policy will last. In the absence of an enforceable contract, some other power must provide that guarantee. In the first instance, the high transaction costs associated with cumbersome process of enacting legislation supply stability. Accordingly, if courts, which must enforce legislation, were agents of the Congress in session, the legislature could cheaply arrange a de facto repeal by asking its courts to rewrite legislation by taking advantage of interpretive leeway. If, on the other hand, the judiciary is independent and interprets legislation in accordance with the enacting Congress' intent, it then supports, rather than interferes with, purchase of legislation by interest groups. However, the independent judiciary may also impose costs by declaring the law

unconstitutional or interpreting it in a way that reduces gains to the group that paid for the law.[6]

The law and economics literature also considers the role of the independent judiciary in enforcing the Constitution. According to Landes and Posner (1975), judicial independence has two purposes in this context. First, it establishes ground rules for a system of interest group politics enforced by the independent judiciary. Second, the Constitution confers specific protective legislation on powerful interests groups willing to purchase such a provision in their favor. For example, broad interpretation of the First Amendment is a form of protective legislation purchased by publishers as an interest group. The Constitution's purpose, supported by the independent judiciary, is to protect groups powerful enough to obtain a constitutional provision or a special interest legislation in their favor.

The conclusions reached by this literature stress that the independent judiciary is an essential element in the observed struggle among interest groups, which is a major component of political practice. Although the judiciary is a critical player in this process, it itself is not "political" but rather is above politics, because it fulfills its role by enforcing the legislative deals of earlier legislatures, not because it has special wisdom, integrity, morality, or commitment to principle.

B. The Hypothesis that the Common Law is Efficient

To the extent to which judicial bodies are independent from political forces and shielded from interest group pressure, the process of judicial lawmaking can be considered immune from the collective decision making failures considered in the previous section.

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[6] Some questions have been raised in the literature regarding the actual level of independence of the judiciary. After all, in the U.S. legal system Congress does have powers, such as appropriations of funds, creation of new judgeships, and rewriting jurisdiction by which they might compel judicial acquiescence. However, self-interested judges can increase their independence by rendering predictable decisions in accord with the original meaning of the statute. According to Landes and Posner (1975), this increases the value of the judiciary to the current legislature because its members know that the courts will enforce the contracts they make. According to the authors, the structure of the judiciary – life tenure, rules against ex parte contact, and impeachment for accepting bribes – also prevents interest groups from influencing judges directly.

In this setting, law and economics scholars formulated a conjecture, known as the efficiency of the common law hypothesis – according to which the common law (i.e., judge-made law) is the result of an effort, conscious or not, to induce efficient outcomes. This hypothesis was first intimated by Coase (1960) and was later systematized and greatly extended by Posner in numerous books and articles. Common law rules attempt to allocate resources in either a Pareto or Kaldor-Hicks efficient manner. Further, common law rules are said to enjoy a comparative advantage over legislation in fulfilling this task because of the evolutionary selection of common law rules through adjudication. Several important contributions provide the foundations for this claim. The scholars who have advanced theories in support of the hypothesis are, however, often in disagreement as to its conceptual basis.

Rubin (1977) provides an important contribution to the emerging efficiency of the common law hypothesis. He maintains that the efficiency of the common law is best explained by an evolutionary model in which parties will more likely litigate inefficient rules than efficient ones. The pressure for the common law to evolve to efficiency, he argues, rests on the desire of parties to create precedent because they have an interest in future similar cases. Rubin thus considers three basic situations: where both parties are interested in creating precedent, where only one party is interested in creating precedent, and where neither party has such an interest.

Where both parties have an interest in future similar cases, and the current legal rule is inefficient, the party held liable will have an incentive to force litigation. Parties will continue to use the courts until the rule is changed. If the current rule is efficient, however, there is no incentive to change it, so it will remain in force. Where only one party has an interest in future similar cases, the incentive to litigate will depend on the allocation of liability. If liability falls on a repeat player, litigation will likely occur, whereas the other party would have no incentive to litigate. As a result, precedents will evolve in the interested party's favor, whether or not the rule is efficient. In the event that neither party is interested in precedents, the legal rule — whether efficient or not — will remain in force, and parties will settle out of court because they lack the incentive to change the current rule. Rubin thus concludes that the common law becomes efficient through

an evolutionary process based on the utility maximizing decisions of litigants, rather than on judges' desires to maximize efficiency.

Rubin's analysis was extended by Priest (1977), who articulated the idea that the common law tends to develop efficient rules independently of judicial bias in decision-making. Indeed, he asserts, efficient rules will develop even despite judicial hostility toward efficient outcomes. Priest parts with Rubin, however, on the source of the tendency toward efficiency, rejecting Rubin's conclusion that this tendency occurs only where both parties to a dispute have an interest in future similar cases and therefore have an incentive to litigate. Instead, he asserts that litigation is driven by the costs of inefficient rules, rather than the desire for precedent.

According to Priest's analysis, inefficient rules impose greater costs on the parties subject to them than do efficient rules, thereby making the stakes in a dispute greater. Where the stakes are greater, litigation is more likely than settlement. Consequently, out of the complete set of legal rules, disputes arising under inefficient rules will tend to be litigated and relitigated more often than disputes arising under efficient rules. This means that the rules not contested will tend to be efficient ones. Because they are less likely to be reviewed, including by judges hostile to efficient outcomes, these rules tend to remain in force. Further, as inefficient rules are reviewed, the process of review provides the chance that they will be discarded in favor of efficient rules which, in turn, are less likely to be reviewed. Thus, the selection of efficient legal rules will continue through the adjudication process.

C. Litigation as a Rule Selection Mechanism

An important component of the theories advanced by Rubin (1977) and Priest (1977) is the criteria for the selection of disputes for litigation. In fact, only a small fraction of disputes go to trial, and even fewer are appealed. Priest and Klein (1984) develop a model of the litigation process that explores the relationship between the set of disputes litigated and the set of disputes settled. According to their one-period model of dispute resolution, the proportion of plaintiff victories in any set of cases will be influenced by the shape of the

distribution of disputes, the absolute magnitude of the judgment, litigation and settlement costs, and the relative stakes of the parties.

Legal disputes are resolved at various stages of a sequential decision-making process in which parties have limited information and act in their own self-interest. An efficient resolution occurs when legal entitlements are assigned to the parties who value them the most, legal liabilities are allocated to the parties who can bear them at the lowest cost, and transaction costs are minimized. Following these premises, Cooter and Rubinfeld (1989) review economic models of legal dispute resolution, attempting to synthesize a model that provides a point of reference necessary to both an understanding of the courts, and deliberation over proposed changes in legal rules. In the first stage of a legal dispute, the underlying event, efficiency requires balancing the cost of harm against the cost of harm avoidance. Because Coasian bargaining is typically not possible, the social costs of harm are externalized. Therefore, an initial allocation of entitlements is essential to creating incentives for efficient levels of activity and precaution. During the second stage, the harmed party decides whether or not to assert a legal claim. This requires the balancing of immediate costs, such as hiring an attorney, and the expected benefits from asserting a claim. In the third stage, after a legal claim is asserted, but before trial, courts encourage parties to bargain together to reach a settlement. If the parties cannot privately settle their dispute, the court performs this function in the final stage, trial.

D. Judicial Incentives and the Common Law

To understand judicial behavior, the first step is to analyze the incentives faced by judges in their judicial role. In the federal system, law and economics has had difficulty explaining judicial behavior in economic terms, in part because the federal judiciary is structured so as to shield judges from direct political or economic constraints. Posner (1994) articulates a positive economic theory of the behavior of federal appellate judges, using a model in which judicial utility is primarily a function of income, leisure, and judicial voting. He argues that appellate judges are ordinary, rational people whose behavior is

somewhat analogous to that of managers of nonprofit enterprises, voters, and theatrical spectators.

In Posner's view appellate judges are like nonprofit managers in that it is difficult to determine the quality or value of the desired output (neutral "justice") from the full range of their services (rulemaking, private dispute resolution, and interposition between the government and its citizens). A rational public is reluctant to buy such services from a profit-making enterprise because a competitive market is not feasible, and they are reluctant to delegate such services to elected officials whose use of political criteria would not be easily monitored. The judiciary is called on to apply neutral justice with much discretionary power but without monetary or political compensation incentives.

The judiciary's nonprofit structure enables competent people to be attracted to judging at lower wages by not forcing judges to work as hard as comparable lawyers might in private practice. However, because most judges continue their judicial activity beyond the usual retirement age of their private sector counterparts, Posner postulates that judges must derive utility in judging beyond just money and leisure. Posner believes that an appellate judge's utility function additionally contains preferences for a good reputation, popularity, prestige, and avoiding reversal. He explicitly excludes from the judicial utility function a desire to promote the public interest because he says such preference cannot be assumed across the board for all individuals. While it might explain the decisions of a few judges, it is not a good standard overall.

Posner analogizes judicial decision making to political voting. There is pure utility in voting, as evidenced by participation in popular elections in which individuals incur a net cost in order to participate in the political process. This analogy suggests that voting on cases is one of the most important sources of judicial utility due to the deference judges' opinions receive by lawyers and the public. Judges further derive a consumption value in deciding for whom or what to vote. Judges balance this consumption against the opportunity cost of decision-making. Leisure-seeking by judges with weak preferences may result in "going along" voting: insistence that a particular decision is coerced by the law, joining opinions containing much dictum with which they disagree, or using procedural rules to

avoid difficult or politically sensitive issues. Posner further suggests that this leisure-seeking explains why judges adhere to *stare decisis*, but not rigidly, given the partially offsetting utility of discretionary power.

Posner's approach supports the theory that the conditions of judicial employment enable and induce judges to vote their values (among which Posner believes efficiency to be particularly influential), and his hypothesis generates a number of testable economic predictions about judicial behavior which have engaged an entire generation of legal and economic scholars.

IV. Customary Law and Decentralized Lawmaking

The hypothesis that legal rules evolve toward efficiency by a process similar to natural selection was originally formulated with reference to judge-made common law rules. While wealth-maximizing hypotheses of the common law have served as a baseline for the analysis of other sources of law, different theoretical frameworks are used to explain the economic structure of non-judge-made rules.

As part of this undertaking, law and economics scholars have examined whether and how far the theory that law is an instrument for maximizing social wealth or efficiency can be extended to other decentralized processes of law formation, such as customary law and social norms.

A. Adjudicating Social Norms

According to the theory of spontaneous law, customary law has a comparative advantage over other institutional sources. The intellectual basis of this claim is related to the proposition that any social arrangement that is voluntarily entered upon by rationally self-interested parties is beneficial to society as a whole. Law and economics has revisited the spontaneous emergence of customary law, emphasizing the issue of legal and institutional change in an

evolutionary setting (See, e.g., Cooter, 1994; Parisi, 1995 and 1998; E. Posner, 1996; Bernstein, 1996).

In the "social contract" framework, customary rules can be regarded as an implied and often non-verbalized exercise of direct legislation by the members of society. Those legal systems that grant direct legal force to customary rules regard custom as a primary, although not exclusive, source of law. In such legal traditions, courts enforce customary rules as if they had been enacted by the proper legislative authority. Custom thus amounts to a spontaneous norm which is recognized by the legal system and granted enforcement as a proper legal rule.

Modern legal systems generally recognize customary rules that have emerged either within the confines of positive legislation (*consuetudo secundum legem*) or in areas that are not disciplined by positive law (*consuetudo praeter legem*). Where custom is in direct conflict with legislation (*custom contra legem*) the latter normally prevails. In some instances, however, a custom supersedes prior legislation (*abrogative custom*), and some arguments have been made in support of emerging practices that conflict with obsolete provisions of public international law (*desuetudo*, or abrogative practice) (Kontou, 1994).[7]

Whenever they are granted legitimate status in a legal system, customary rules are usually given the same effect as other primary sources of law. Although often subordinated to formal legislation, customary rules derive their force from the concurrence of a uniform practice and a subjective belief that adherence to them is obligatory (*opinio iuris*), without necessarily being formally incorporated into any written body of law. For this reason, they are usually classified as "immaterial" sources of law (H.L.A. Hart, 1961, p. 246-7;

[7] Judicial recognition of customary practice amounts to a declaratory (rather than constitutive) function that treats custom as a legal fact. The legal system "finds" the law by recognizing such practices, but does not "create" the law. The most notable illustration is the system of international law, where, absent a central legislative authority, custom stands next to treaties as a primary source of law. (See, e.g. Article 38 (1) of the *Statute of the International Court of Justice*; and Restatement 102 of the *Foreign Relations Law of the United States*).

Brownlie, 1990). This notion implies that the custom remains the actual source of law even after its judicial recognition. In this setting, the judicial decisions that recognize a custom offer only persuasive evidence of its existence and do not themselves become sources of law. In turn, this prevents the principle of *stare decisis* from crystallizing customary law.

B. The Anatomy of Customary Law

The theory of customary law defines custom as a practice that emerges outside of legal constraints, and which individuals and organizations spontaneously follow in the course of their interactions out of a sense of legal obligation. Gradually, individual actors embrace norms that they view as requisite to their collective well-being. An enforceable custom emerges from two formative elements: (i) a quantitative element consisting of a general or emerging practice; and (ii) a qualitative element reflected in the belief that the norm generates a desired social outcome.

1. The Quantitative Element. The quantitative requirements for the formation of customary law concern both the length of time and the universality of the emerging practice. Regarding the time element, there is generally no universally established minimum duration for the emergence of customary rules. Customary rules have evolved from both immemorial practice and a single act. Still, French jurisprudence has traditionally required the passage of forty years for the emergence of an international custom, while German doctrine generally requires thirty years. (See Tunkin (1961); and Mateesco (1947)). Naturally, the longer the time required to form a valid practice, the less likely it is for custom to effectively anticipate the intervention of formal legislation, and to adapt to changing circumstances over time.

Regarding the condition of universality, international legal theory is ambivalent. Charney (1986) suggests that the system of international relations is analogous to a world of individuals in the

state of nature, dismissing the idea that unanimous consent by all participants is required before binding customary law is formed. Rather than universality, recent restatements of international law refer to "consistency" and "generality."[8]

With regard to rules at the national or local level, the varying pace with which social norms are transformed suggests that no general time or consistency requirement can be established as an across-the-board condition for the validity of a custom. Some variance in individual observation of the practice should be expected because of the stochastic origin of social norms. A flexible time requirement is particularly necessary in situations of rapid flux, where exogenous changes are likely to affect the incentive structure of the underlying relationship.

2. The Qualitative Element. The second formative element of a customary rule is generally identified by the phrase *opinio iuris ac necessitatis*, which describes a widespread belief in the desirability of the norm and the general conviction that the practice represents an essential norm of social conduct. This element is often defined in terms of necessary and obligatory convention. (Kelsen, 1939 and 1945; D'Amato, 1971; and Walden, 1977). The traditional formulation of *opinio iuris* is problematic because of its circularity. It is quite difficult to conceptualize that law can be born from a practice which is already believed to be required by law.

The practical significance of this requirement is that it narrows the range of enforceable customs. Only those practices recognized as socially desirable or necessary will eventually ripen into enforceable customary law. Once there is a general consensus that members of a

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[8] (See D'Amato, 1971). Where it is impossible to identify a general practice because of fluctuations in behavior, the consistency requirement is not met. (See *Asylum case* (1950), at 276-7; and *Wimbledon case* (1923), Ser. A, no. 1). Similarly, more recent cases in international law restate the universality requirement in terms of "increasing and widespread acceptance." (See, e.g., *Fisheries Jurisdiction case* (1974), at 23-6; *North Sea Continental Shelf cases* (1969), at 42), allowing special consideration for emerging general norms (or local clusters of spontaneous default rules) that are expected to become evolutionarily stable over time.

group ought to conform to a given rule of conduct, a legal custom can be said to have emerged when some level of spontaneous compliance with the rule is obtained. As a result, observable equilibria that are regarded by society as either undesirable (e.g., a prisoner's dilemma uncooperative outcome) or unnecessary (e.g., a common practice of greeting neighbors cordially) will lack the subjective and qualitative element of legal obligation and, therefore, will not generate enforceable legal rules.

C. The Limits of Customary Law

Customary rules are generally accepted by the community, with a larger share of rules followed spontaneously by the community and a consequent reduction in law enforcement costs. In the decentralized dynamic of spontaneous law, individual decision-makers directly perceive the costs and benefits of alternative rules, and reveal their preferences by supporting or opposing their formation. The formative process of customary law proceeds through a purely inductive accounting of subjective preferences. Through his own action, each individual contributes to the creation of law. The emerging rule thus embodies the aggregate effects of independent choices by various individuals that participate in its formation. This inductive process allows individuals to reveal their preferences through their own action, without the interface of third-party decision-makers.

The analogy between customary rules and spontaneous market equilibria, however, calls for an assessment of the potential insufficiencies of the spontaneous processes of law formation. The literature in this area is relatively thin and much work still needs to be done to develop a coherent understanding of the limits of spontaneous sources of law.

1. Path Dependence and the Idiosyncracies of Customary Law. Norms and conventions vary from place to place. Any theory about the efficiency of spontaneous law should explain the diversity of

norms and conventions across time and space. In my view, there are two primary ways to provide such an explanation.

The first is to look for idiosyncratic environmental or institutional factors which might attribute to the diversity of observed rules. If the underlying social, economic, or historical realities are found to be different from one another, different norms or conventions should be expected. Rules, norms and conventions develop in response to exogenous shocks through a natural process of selection and evolution. This "survival of the fittest" explanation would suggest that whatever exists in equilibrium is efficient, given the current state of affairs. This belief, borrowed from Darwinian evolutionism, is pervasive in the law and economics literature, and, when applied to spontaneous law, risks becoming a tautological profession of faith. Ironically, we should note that the originators of such a claim, socio-biologists, have now widely refuted its validity.

The second way to reconcile the efficiency claim to the observed diversity of spontaneous rules is to consider the role of path dependence in the evolution of norms and conventions. Evolution toward efficiency takes place with some random component. Random historical and natural events (the random element of chaos theory) determine the choice of the initial path. This may be the case particularly where initial choices are made under imperfect information. Evolution then continues toward efficiency along different paths, with results that are influenced and constrained by the initial random conditions.

If we agree that path dependence has something to do with the emergence and evolution of customary law, we should follow this logic to its conclusion, revisiting the very foundations of the efficiency claim. The main question is whether path dependence could ever lead to inefficient results. According to current research (Roe, 1996), path dependence may lead to inefficient equilibria. Once a community has developed its norms and conventions, the costs of changing them may outweigh the benefits. Less efficient rules may persist if the transition to more efficient alternatives is costly. Thus, if one allows for some randomness and path dependence, norms

and conventions, although driven by an evolution-toward-efficiency dynamic, may stabilize around points of local, rather than global, maximization. Our history, in this sense, constrains our present choices. We may wish we had developed more efficient customs and institutions, but it would be foolish now to attempt to change them. The claim of efficiency of spontaneous law thus becomes a relative one vis-a-vis the other sources of law. The point then becomes that of weighing the relative advantages of spontaneous lawmaking against the attributes of engineered legislation, taking full account of the pervasive public choice and information problems underlying such alternatives.

2. Rational Abstention and Norm Manipulation. A public choice analysis of customary law should further consider the vulnerability of norms and customs to the pressure of special interest groups. This line of analysis—relatively undeveloped in the current literature—should search for parallels between the legislative process and the dynamic of norm formation. In that setting, the opportunity for collective beliefs and customs to be manipulated by special interest groups should be analyzed. Any claim that customary sources are superior to proper legislation will have to rest on a solid understanding of the relative sensitivity of each source to possible political failures.

The application of a well known theorem of public choice to the study of customary law generates very interesting results. Unlike legislation in a representative democracy, customary law rests on the widespread consensus of all individuals affected by the rule. If principal-agent problems are likely to arise in a political world characterized by rational ignorance and rational abstention of voters, no such problems appear to affect customary sources. Individuals are bound by a customary rule only to the extent that they concurred—actively or through voluntary acquiescence—in the formation of the emerging practice.

Imperfect information, however, may induce voluntary acquiescence—or even active concurrence—to an undesirable practice.

Economic models of cascade or bandwagon behavior have shown how inferior paths can be followed by individuals who rely on previous choices undertaken by other subjects, and value such observed choices as signals of revealed preference. Economic models have shown that, when information is incomplete, excessive weight can be attached to the signal generated by others. Others' choices may be followed even when the agent's own perception conflicts with the content of the observed signal. In this way, a biased or mistaken first-mover can generate a cascade of wrong decisions by all his followers, with a result that may prove relatively persistent under a wide array of conditions.

Cascade arguments may also unveil the relative fragility of spontaneous sources of law in light of the possible manipulation of collective beliefs through biased leadership. If information is imperfect, the input of politically biased first-movers may generate undesirable norms. These norms may persist because of the weight attached to the choices of our predecessors. Thus, once generated, wrong beliefs may become stable and widespread in any community of imperfect decision makers.

3. Collective Action Problems in Customary Legal Regimes. Another potential weakness of customary law is revealed by the application of a collective action framework to the study of the formation and enforcement of customary rules. We can start the analysis by observing that legal rules and law enforcement are public goods. In the case of customary rules, collective action problems may thus arise at two distinct stages: first, in the formative process of customary rules; and second, in the enforcement of the emerged customs.

The process of a custom formation relies on the spontaneous and widespread acceptance of a given rule by the members of a group. Individuals often face a private cost when complying with the precepts of the rule, and they generally derive a benefit because of the compliance of others with existing rules. Thus, the formation of customary law can be affected by a public good problem. When

discussing the conditions under which customary rules can effectively develop, I illustrated the analysis with a game-theoretic framework. The public good problem considered here is in many respects similar to the strategic tension that we have examined in the context of customary law formation. If individuals face a private cost and generate a public benefit through norm creation, there will be a suboptimal amount of norms created through spontaneous processes. Any individual would like others to observe a higher level of norm compliance than he or she observed. The resulting level of norm compliance would thus be suboptimal. Collective action problems in the formation of customary rules have traditionally been corrected by norms which sanctioned opportunistic double standards, and by metarules imposing reciprocity constraints on the parties.

More serious collective action problems emerge in the enforcement of spontaneous norms. If the enforcement of norms is left to the private initiative of individual members of the group, a large number of cases will be characterized by a suboptimal level of enforcement. Punishing violators of a norm creates a public good because of the special and general deterrent effect of the penalty. Yet imposition of the penalty is left to private initiative, punishers would be willing to enforce norms only to the point which the private marginal cost of enforcement equals its private marginal benefit. This equilibrium obviously diverges from the social optimum, where enforcement would be carried out until the marginal cost equals the social, rather than private, marginal benefit.

In sum, collective action problems may be pervasive in the enforcement of customary rules, with a consequential risk that enforcement will be suboptimal. This conclusion suggests that the decentralized process of law formation may be successfully coupled with a centralized mechanism of law enforcement. In this way, the advantages that customary sources have in gathering diffuse information will be available, free from the collective action problems that typically affect decentralized processes of law enforcement.

IV. Conclusions

This article analogizes the production of legal rules to a production process in the marketplace. I explore the mechanisms that determine the emergence and evolution of legal rules, considering the competing sources of law and evaluating the role of market forces in determining the success and evolution of alternative legal rules. The sources of law taken into consideration range from spontaneous customary rules to judge-made rules and proper legislation.

Market forces operate in several ways in the evolution of legal rules. Different strengths and weaknesses characterize the alternative sources of law considered in this study. Likewise, different types of costs are shown to be inherent in the different evolutionary mechanisms. In exploring the mechanisms that determine the emergence and evolution of legal rules, it was possible to observe that market forces operate in several ways in the evolution of legal rules.

The institutional design of lawmaking should apply these principles exploit the comparative advantage of different legal and social institutions in the production of legal rules. The traditional approach to lawmaking is enriched by a consideration of the comparative advantage of alternative sources of law through the lens of functional law and economics and public choice theory.

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