

Law and economics

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Law and Economics, or economic analysis of law is an approach to legal theory that applies methods of economics to law. It includes the use of economic concepts to explain the effects of laws, to assess which legal rules are economically efficient, and to predict which legal rules will be promulgated.

Relationship to other disciplines and approaches

As used by lawyers and legal scholars, the phrase "law and economics" refers to the application of the methods of economics to legal problems.

Because of the overlap between legal systems and political systems, some of the issues in law and economics are also raised in political economy and political science. Most formal academic work done in law and economics is broadly within the Neoclassical tradition. Approaches to the same issues from Marxist and critical theory/Frankfurt School perspectives usually do not identify themselves as "law and economics". For example, research by members of the critical legal studies movement considers many of the same fundamental issues as does work labeled "law and economics". The one wing that represents a non-neoclassical approach to "law and economics" is the Continental (mainly German) tradition that sees the concept starting out of the Staatswissenschaften approach and the German Historical School of Economics; this view is represented in the Elgar Companion to Law and Economics (2nd ed. 2005) and - though not exclusively - in the European Journal of Law and Economics. Here, consciously non-neoclassical approaches to economics are used for the analysis of legal (and administrative/governance) problems.

Origin and history

As early as in the 18th century, Adam Smith discussed the economic effect on mercantilist legislation. However, to apply economics to analyze the law regulating nonmarket activities is relatively new. In 1961, Ronald Coase and Guido Calabresi independently from each other published two groundbreaking articles: "The Problem of Social Cost" and "Some Thoughts on Risk Distribution and the Law of Torts". This can be seen as the starting point for the modern school of law and economics.

In the early 1970s, Henry Manne (a former student of Coase) set out to build a Center for Law and Economics at a major law school. He began at Rochester, worked at Miami, but was soon made unwelcome, moved to Emory, and ended at George Mason. The latter soon became a center for the education of judges -- many long out of law school and never exposed to numbers and economics. Manne also attracted the support of the John M. Olin Foundation, whose support accelerated the movement. Today, Olin centers (or programs) for Law and Economics exist at many universities.

Positive and normative law and economics

Economic analysis of law is usually divided into two subfields, positive and normative.

Positive law and economics

Positive law and economics uses economic analysis to predict the effects of various legal rules. So, for example, a positive economic analysis of tort law would predict the effects of a strict liability rule

as opposed to the effects of a negligence rule. Positive law and economics has also at times purported to explain the development of legal rules, for example the common law of torts, in terms of their economic efficiency.

Normative law and economics

Normative law and economics goes one step further and makes policy recommendations based on the economic consequences of various policies. The key concept for normative economic analysis is efficiency, in particular, allocative efficiency.

A common concept of efficiency used by law and economics scholars is Pareto efficiency. A legal rule is Pareto efficient if it could not be changed so as to make one person better off without making another person worse off. A stronger conception of efficiency is Kaldor-Hicks efficiency. A legal rule is Kaldor-Hicks efficient if it could be made Pareto efficient by some parties compensating others as to offset their loss.

Important scholars

Important figures include the Nobel Prize winning economists Ronald Coase and Gary Becker, U.S. Court of Appeals for the Seventh Circuit, judges Frank Easterbrook and Richard Posner, and other distinguished scholars such as Robert Cooter, Henry Manne and William Landes. Guido Calabresi, judge for the U.S. Court of Appeals for the Second Circuit, author of the 1970 book, *The Cost of Accidents: A Legal and Economic Analysis*, wrote in depth on this subject, with *Costs of Accidents* being cited as influential in its extensive treatment of the proper incentives and compensation required in accident situations. Calabresi took a different approach in his 1985 book, *Ideals, Beliefs, Attitudes, and the Law*, where he argued, "who is the cheapest avoider of a cost, depends on the valuations put on acts, activities and beliefs by the whole of our law and not on some objective or scientific notion (69)."

Influence

In the United States, economic analysis of law has been extremely influential. Judicial opinions utilize economic analysis and the theories of law and economics with some regularity. The influence of law and economics has also been felt in legal education. Many law schools in North America, Europe, and Asia have faculty members with a graduate degree in economics. In addition, many professional economists now study and write on the relationship between economics and legal doctrines. Anthony Kronman, former dean of Yale Law School, has written that "the intellectual movement that has had the greatest influence on American academic law in the past quarter-century [of the 20th Century]" is law-and-economics.

Critique

Despite its influence, the law and economics movement has been criticized from a number of directions. This is especially true of normative law and economics. Because most law and economics scholarship operates within a neoclassical framework, fundamental criticisms of neoclassical economics have been applied to work in law and economics.

Rational choice theory

Within the legal academy, law and economics has been criticized on the ground that rational choice theory in economics makes unrealistic simplifying assumptions about human nature (see rational choice theory (criminology)); Posner's application of law and economic reasoning to rape and sex may be an example of this. Liberal critics of the law and economics movements have argued that normative economic analysis does not capture the importance of human rights and concerns for distributive justice. Some of the heaviest criticisms of the "classical" law and economics come from the critical legal studies movement, in particular Duncan Kennedy and Mark Kelman.

Pareto efficiency

Relatedly, additional critique has been directed toward the assumed benefits of law and policy designed to increase allocative efficiency; when such assumptions are modeled on "first-best" (Pareto optimal) general-equilibrium conditions. Under the theory of the second best, for example, if the fulfillment of a subset of optimal conditions cannot be met under any circumstances, it is incorrect to conclude that the fulfillment of any subset of optimal conditions will necessarily result in an increase in allocative efficiency.

Consequently, any expression of public policy whose purported purpose is an unambiguous increase in allocative efficiency (for example, consolidation of research and development costs through increased mergers and acquisitions resulting from a systematic relaxation of anti-trust laws) is, according to critics, fundamentally incorrect; as there is no general reason to conclude that an increase in allocative efficiency is more likely than a decrease.

Essentially, the "first-best" neoclassical analysis fails to properly account for various kinds of general-equilibrium feedback relationships that result from intrinsic Pareto imperfections.

Another critique comes from the fact that there is no unique optimal result. Warren Samuels in his 2007 book, *The Legal-Economic Nexus*, argues, "efficiency in the Pareto sense cannot dispositively be applied to the definition and assignment of rights themselves, because efficiency requires an antecedent determination of the rights (23-4)."

Responses

Law and economics has adapted to some of these criticisms (see "contemporary developments," below). One critic, Jon D. Hanson of Harvard Law School, argues that our legal, economic, political, and social systems are unduly influenced by an individualistic model that assumes "dispositionism" -- the idea that outcomes are the result of our "dispositions" (economists would say "preferences"). Instead, Hanson argues, we should look to the "situation", both inside of us (including cognitive biases) and outside of us (family, community, social norms, and other environmental factors) that have a much larger impact on our actions than mere "choice." Hanson has written many law review articles on the subject and has books forthcoming.

Contemporary developments

Law and economics has developed in a variety of directions. One important trend has been the application of game theory to legal problems. Other developments have been the incorporation of behavioral economics into economic analysis of law, and the increasing use of statistical and econometrics techniques. Within the legal academy, the term socio-economics has been applied to economic approaches that are self-consciously broader than the neoclassical tradition.